Partners for Financial Stability

Regional Report

June 2011

This Country Financial Sector Overview (High Level) is part of an annual series of Overviews that address financial sector challenges and USAID programming needs in each of the twelve countries in Southeast Europe and Eurasia participating in USAID's Partners for Financial Stability ("PFS") program.

The subject country's financial sector is compared and contrasted against other emerging European countries and against a 'global benchmark' which is taken from one of these sources depending upon data availability and other considerations: the Eurozone countries' average; Korea (as a proxy for advanced developing countries); or a best-practices standard selected by PFS.

***This Overview considers five key aspects of the financial sector: macroeconomic and financial sector stability; size; sophistication; access** to financial services; and the financial sector enabling environment.*

All of the data referenced in this document was obtained from public sources and the opinions expressed herein are based upon analysis by PFS.

About PFS

The United States Agency for International Development (USAID) Partners for Financial Stability (PFS) Program is led by the Office of Economic Growth in the Europe and Eurasia Bureau (E&E). The project addresses the challenges facing the financial sector in 12 Partner Countries: Albania, Bosnia and Herzegovina, Kosovo, Macedonia, Montenegro and Serbia (Southeastern Europe) as well as Armenia, Azerbaijan, Belarus, Georgia, Moldova, and Ukraine (Eurasia). Other countries in the E&E region that are considered USAID 'graduates' serve as Mentor Countries in the PFS Program.

The PFS Program is designed to complement the work of the bilateral USAID missions' Economic Growth programs in the region by bringing together regional players to address regional challenges. PFS Program activities include benchmarking studies, conferences, knowledge sharing, research and technical assistance. The PFS Program addresses the challenges of the financial systems in these regions, working in a broad range of subject areas including anti-money laundering, banking and non-bank financial regulation, supervision and institutional rehabilitation, corporate governance, financial literacy, access to finance and implementation of international standards in financial sector reporting.

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1.1. Background

This Regional PFS Report has been produced with four major objectives:

- To provide data and analysis for USAID and others to better understand weaknesses and gaps in financial sector development in Southeast Europe (SEE) and Eurasia;
- To briefly assess the consequences of the global financial crisis on the financial sectors in the region;
- To evaluate and compare financial sector disparities across regions and countries;
- To propose initiatives to USAID and others that would promote financial sector stability and economic growth to the countries of the region.

This Report provides an overview of a number of key, high level indicators of financial sector development in the 12 PFS Beneficiary countries against comparable data for other "transition" countries in Europe and Eurasia as well as more advanced economies. These indicators are:

- Financial and Macroeconomic Stability
- Financial Sector Size
- Financial Sector Sophistication
- Access to Financial Services
- Financial Sector Enabling Environment

Global best practice benchmarks have mainly been taken from the Eurozone, although in some cases non-European countries have also been added (e.g., Financial Sector Stability). In other cases, Korea has been utilized.

The methodology is designed to be broadly consistent with the general scoring or ranking system utilized by USAID/E&E Bureau in its Monitoring Country Progress reports based on a scale of "0" (worst) to "5" (best). However, there are differences between the two, particularly in terms of the use of a sliding scale for country and regional scores. (See Methodological Notes at the end of the report.)

Regional groupings are largely consistent with USAID groupings, as follows (with PFS Beneficiary countries in bold).

- CEE NORTHERN TIER: Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, Slovenia.
- CEE SOUTHERN TIER: **Albania, Bosnia**, Bulgaria, Croatia, **FYR Macedonia, Kosovo, Montenegro**, Romania, **Serbia**.

- EURASIA[1]: **Armenia, Azerbaijan, Belarus, Georgia**, Kazakhstan, Kyrgyz Republic, **Moldova,** Russia, Tajikistan, Turkmenistan, **Ukraine**, Uzbekistan.

The "transition" economies are loosely defined as the countries covered by the EBRD (plus the Czech Republic). Advanced economies are generally presumed to be Eurozone, although for most of the key financial stability indicators, "advanced economies" also include other countries outside the Eurozone that are members of the OECD. In certain cases, Korea is utilized as a proxy for advanced economies. Korea was specifically chosen because of its relatively recent emergence as an advanced economy, having also experienced hardship during the Asian financial crisis in 1998. Likewise, comparisons are also made with Turkey and Croatia as examples of non-OECD countries that are more advanced than the PFS Beneficiary countries, and whose performance in many areas can serve as targets for future development of the PFS Beneficiary countries over the next five to 10 years. Like Korea, Turkey has emerged in recent years after having experienced major financial crisis (in this case, more than once).

1.2. Key Findings

Compared with global benchmarks for advanced economies, the financial sectors in the PFS Beneficiary countries are very small, unsophisticated, and do not provide broad access to financial services. In this regard, the PFS Beneficiary countries in the CEE SOUTHERN TIER have less of a gap with advanced economies in financial sector size and access. The PFS Beneficiary countries in EURASIA actually show higher enabling environment scores than the countries in the CEE SOUTHERN TIER due to recent reforms and improvements in procedures for property registration and contract enforcement.

The PFS Beneficiary countries also have financial systems and economies that are less stable than those of advanced economies, notwithstanding the recent turbulence experienced in Eurozone and other advanced economies. However, the stability gap between the PFS Beneficiary countries in CEE SOUTHERN TIER and EURASIA on the one hand and advanced economies on the other is less than the gaps that exist in terms of size, sophistication and access. This is likely a transitory development for the PFS countries, considering that economic dislocation of the last few years in advanced economies has been the greatest since the 1930s. As the advanced economies return to growth and stability, the gaps between macroeconomic and financial sector stability in the PFS Beneficiary countries and the advanced economies could increase. This is particularly challenging for PFS countries as they seek to increase lending in pursuit of economic growth.

The presence in many of the PFS countries of EU-based banks is a double-edged sword. These banks can help significantly with the effort to stabilize the financial sector. However, some EU-based banks that have expanded into these emerging markets over the last two decades have also faced their own challenges of solvency and liquidity. Thus, their presence can help in PFS Beneficiary countries, but the presence of EU-based banks is not a panacea. Other banks will also need to adhere to recognized standards and boost capacity (and investment) to more fully develop the financial systems in the PFS Beneficiary economies.

[1] Mongolia is not a part of USAID's EURASIA group, but has been included in some of the statistics as part of the EBRD 29. Some references to Mongolia are made in this report. However, Mongolia's data have not been included as part of the regional averages.

With size, sophistication and access being serious weaknesses in their financial systems, key challenges for these countries are how to (1) encourage more sustainable levels of credit to creditworthy borrowers in the private sector, and (2) develop the non-bank financial sector. There are no easy or short-term solutions, although initiatives that support these objectives are described below in the Executive Summary.

While the financial sectors in these countries have made progress over the last two decades, there is a limit to how far they can advance if the real sector does not reform and develop. That most of these countries' financial sectors and economies have shown some underlying stability during the crisis reflects their progress in monetary policy, fiscal management, banking supervision, and the enabling environment – tasks which USAID and other international development organizations helped initiate and support. However, it is also indicative of how detached the Beneficiary countries are from the global financial system. Without additional reforms in the real economy in most countries, there will be a limit to the capacity of the financial sector to support higher rates of economic growth.

Findings from the review on a regional basis show that EURASIA is the weakest region of the three USAID/E&E Bureau regions, followed by CEE SOUTHERN TIER and then CEE NORTHERN TIER. The following patterns are evident for the 12 Beneficiary countries. (More specific information per country as well as how performance compares with Turkey, Croatia and global benchmarks is found in the main report.)

- EURASIA is the weakest region in most cases, reflecting lower levels of financial and macroeconomic stability, financial sector size and sophistication, and access to financial services. This applies to the PFS Beneficiary countries in the region, whose scores are generally lower than scores in the other regions. Despite other weaknesses, EURASIA region scores for enabling environment measures are higher than CEE SOUTHERN TIER, including those in PFS countries. This is largely due to better scores in the Financial Sector Enabling Environment category (mainly for the ease of property registration and contract enforcement).

- CEE SOUTHERN TIER scores are lower than in the CEE NORTHERN TIER countries for Financial Sector and Macroeconomic Stability, Size and Sophistication. However, CEE SOUTHERN TIER countries, including PFS Beneficiary countries in the region, score higher than CEE NORTHERN TIER countries in Access to Financial Services.

- The PFS Beneficiary countries in EURASIA and CEE SOUTHERN TIER generally rank lower than or equal to their respective regions as a whole. Exceptions are EURASIA PFS Beneficiary countries which scored higher than the regional average for Financial Sector and Macroeconomic Stability, and slightly higher in terms of Enabling Environment indicators. This has more to do with Kazakhstan's poor performance as a non-PFS Beneficiary country in terms of financial stability, and enabling environment reforms in the PFS countries that led to better scores than in many Central Asian countries. In CEE SOUTHERN TIER, the PFS Beneficiary countries lag their peers in all categories, reflecting gaps that remain vis-à-vis EU members (i.e., Bulgaria, Romania) or those close to joining the EU (i.e., Croatia).

The reasons for the regional differentiation are many, but include:

- *Soundness of banks*, with banks in general experiencing rising levels of non-performing loans, but EURASIA banks in particular experiencing high levels of non-performing loans and currently trying to compensate with very high capital adequacy ratios.

- *Confidence in the currency and monetary (anti-inflation) policy*, with EURASIA and CEE SOUTHERN TIER depositors showing a strong preference for foreign exchange-denominated deposit instruments. This is in contrast to the CEE NORTHERN TIER countries whose foreign exchange share of deposits is much lower.

- *Macroeconomic policies*, with all three regions showing differing patterns and results, including instability in key areas. EURASIA has been particularly vulnerable to high inflation rates, deep current account deficits and low levels of gross foreign exchange reserves[2], although some countries in the region have contained inflation rates and reduced current account deficits due to the economic slowdown. The latter pattern has also been the case in CEE SOUTHERN TIER.

- *General development of the financial sector*, as reflected in the size and sophistication of financial markets. These trends reflect the level of overall economic reforms, as EURASIA continues to show very low levels of banking system, stock market and insurance sector development relative to GDP. These parts of the financial sector are also underdeveloped in CEE SOUTHERN TIER countries, although they are more developed than in EURASIA. The CEE NORTHERN TIER countries have more developed banking systems, but non-bank financial services are not much different than CEE SOUTHERN TIER as a share of GDP. Broadly, this translates into more sophisticated systems in CEE NORTHERN TIER countries when compared with the other two regions.

- *Access to financial services*, where patterns have differed in all three regions. CEE NORTHERN TIER countries have higher borrower density than the other two regions, reflecting greater access to credit. However, their scores were lowered by negative real interest rate spreads in 2007-08 (since corrected) which adversely impacted bank earnings and may have reflected overheated lending patterns. This latter pattern was also true in EURASIA. By contrast, CEE SOUTHERN TIER countries have maintained reasonable real interest rate spreads, but like EURASIA, show low levels of borrower density, reflecting limited access to credit.

- *The financial sector enabling environment*, where PFS Beneficiary countries in the CEE SOUTHERN TIER show a number of weaknesses in property registration and contract enforcement, all of which weaken the environment for lending, investment, and general risk-taking. In this regard, EURASIA scores are higher than CEE SOUTHERN TIER. However, EURASIA scores are lower than CEE SOUTHERN TIER countries with regard to credit information services. CEE NORTHERN TIER countries outperform the other regions except for slow processing of property registration and contract enforcement measures.

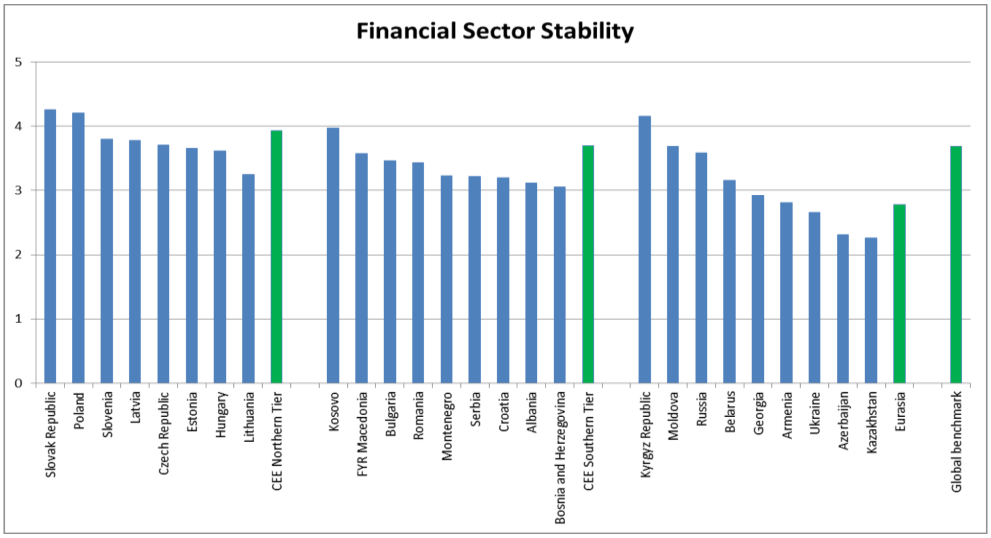
These differentiations provide guidance on how assistance programs can be structured to address critical challenges and constraints in CEE SOUTHERN TIER and EURASIA. Regional comparisons are summarized below based on the five broad categories utilized for the assessment. (More specific detail on country performance within and across regions is found in the body of the report.)

[2] Azerbaijan is an important exception.

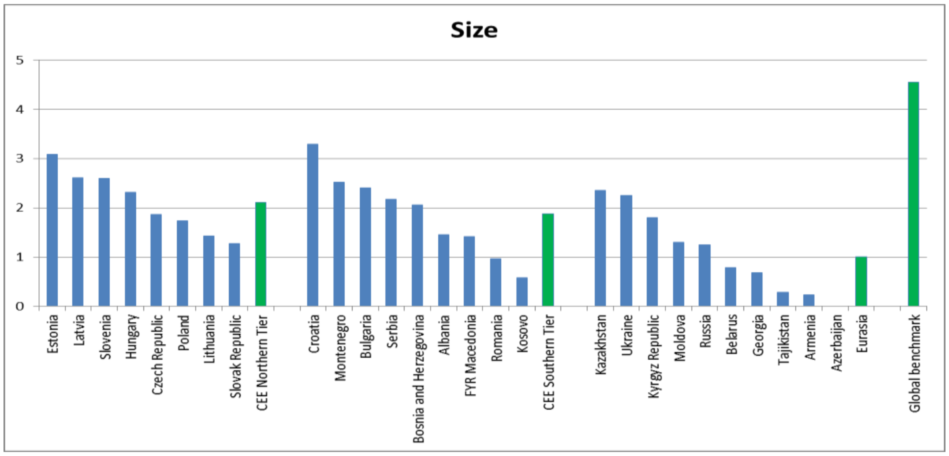
Financial Sector and Macroeconomic Stability

While PFS Beneficiary countries are emerging from the global financial crisis, they will continue to face significant challenges in terms of macroeconomic and financial sector stability. Banking systems are now more stable than they were in 2007-08, but they remain small, while non-bank financial markets are embryonic. Their small size and challenges with non-performing loans will constrain earnings and capital formation, thereby limiting their capacity to finance the private sector. Meanwhile, ongoing weaknesses in the real economy (including the private sector) that are manifested in uncompetitive productivity levels, limited export capacity, and high unemployment limit the creditworthiness of enterprises and households, thereby limiting the potential market for banks and non-bank financial institutions.

EURASIA has major challenges regarding financial sector and macroeconomic stability, and these countries remain vulnerable to another round of macroeconomic or financial sector weakening. Non-performing loans and loan-to-deposit ratios are very high, indicating that banks are exposed to serious credit quality and liquidity challenges, while companies encounter higher borrowing costs and/or reduced access to credit. This prompts banks to maintain very high capital adequacy ratios to offset solvency risks. While these actions strengthen underlying banking system soundness, such patterns also tend to reduce bank earnings over time, negatively impacting investment in the financial sector. Lending to the private sector showed excessive growth leading up to the financial crisis, leading to high inflation rates and deep current account deficits (notwithstanding improvements since 2009) as well as low levels of gross reserves. These areas of vulnerability are offset to some degree by reasonable fiscal balances and low levels of gross indebtedness.



CEE SOUTHERN TIER countries are more stable than EURASIA, and somewhat comparable to CEE NORTHERN TIER countries, albeit with differing characteristics. Non-performing loans have increased significantly in recent years, and this has reduced banks' earnings. Banks' balance sheets have also shown far less credit and deposit growth (and in some cases a halt) since the crisis began, accompanied by high levels of foreign exchange exposure in both loans and deposits. High levels of foreign exchange-denominated lending highlight the banking sector's exposure to high levels of exchange rate risk, while the high proportion of foreign currency-denominated deposits shows lingering concerns about the underlying stability of domestic exchange rates. All of this was particularly challenging through 2008 due to the very deep and unsustainable current account deficits of the region, much of it reflecting financing for the purchase of private consumption that generated limited value added. These vulnerabilities have been offset by low and stable inflation rates since 2009 and reasonable fiscal deficits in most countries. High and stable capital adequacy ratios, reasonable provisions for loan losses, balanced loan-to-deposit ratios, liquidity support from the IMF, regional agreements with key foreign banks to ensure continued financing, and medium levels of gross reserves have helped to offset the adverse impact of the financial crisis in the region.



CEE NORTHERN TIER countries, none of which are PFS Beneficiary countries, are more stable than EURASIA, and generally comparable to CEE SOUTHERN TIER countries. However, within this region, the Baltic states have experienced high levels of turbulence. Combined with Hungary, these countries are less stable overall than other countries in the region. In general, and as in the other regions, non-performing loans have risen significantly. This has reduced bank earnings to the point where the banks generated losses in 2009 and were near zero in 2010. Credit contracted and deposit growth slowed in 2009. On the positive side, these banking sector weaknesses are partly offset by reasonable provisioning for loan losses, comparatively low levels of foreign exchange exposure, and low inflation rates and current account surpluses since 2009 (reflecting the economic slowdown). However, several countries of the region continue to be burdened with fairly deep fiscal deficits, comparatively high levels of indebtedness, fairly low levels of gross reserves, and weak bank earnings.

Financial Sector Size

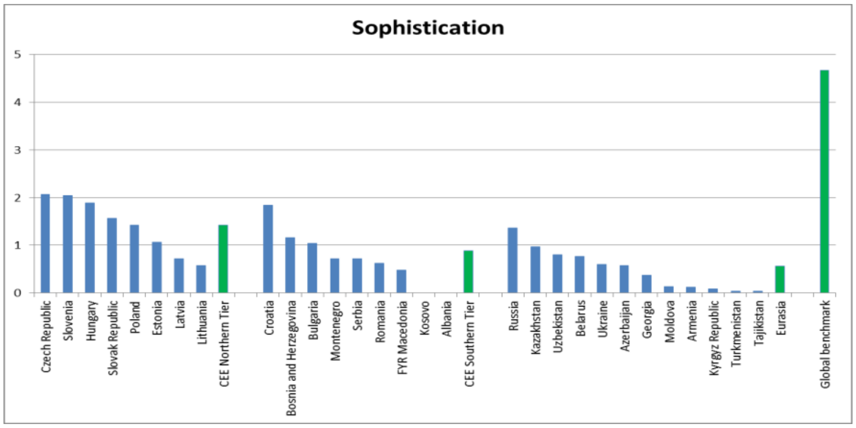
The PFS Beneficiary countries have very small financial sectors. This is true for the banking system, and particularly true in non-bank financial services. Such limitations mean there is less financing available for the private sector, and less of a range of products and services.

EURASIA financial sectors are very small (1.01 on a scale of 5.00), and considerably smaller than their peers in the CEE NORTHERN (2.11 score) and SOUTHERN TIER (1.89 score) countries by all measures (e.g., deposits, credit, capital, stock market capitalization and insurance premiums all as a share of GDP). This hampers the private sector's ability in EURASIA to grow and create jobs, particularly in the PFS Beneficiary countries, whose financial sectors are even smaller than the regional norm in both EURASIA (PFS at 0.83) and CEE SOUTHERN TIER (PFS at 1.70).

The size of the financial sectors in the CEE NORTHERN and SOUTHERN TIER countries is small when compared with advanced economies. CEE NORTHERN and SOUTHERN TIER financial sectors are approximately the same size as a share of GDP, although the CEE NORTHERN TIER countries have higher levels of bank credit and larger insurance sectors. The CEE SOUTHERN TIER countries' financial sectors are slightly higher in terms of deposits, bank capital and stock market capitalization as a share of GDP (although data for the last measure are suspect).

Financial Sector Sophistication

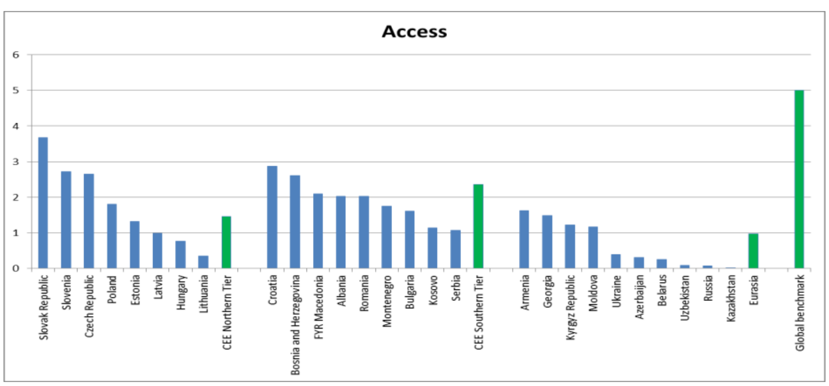
When compared with advanced economies, all three regions show large gaps in terms of financial sector sophistication. PFS Beneficiary countries in the EURASIA and CEE SOUTHERN TIER regions had very similar scores on average. In general, financial sector sophistication in these two regions is considered low--0.55 on average on a scale of 5.00, with the Eurozone score at 4.67. The CEE NORTHERN TIER countries scored 1.42, which is higher than EURASIA and CEE SOUTHERN TIER but well below the Eurozone. As with EURASIA and CEE SOUTHERN TIER, CEE NORTHERN TIER development is mainly related to the banking sector. Non-bank financial services remain relatively limited as measured by bond and stock trading volume, and stock market capitalization. The insurance sector also shows low levels of penetration as a share of GDP. Thus, **overall, all three regions are lacking in sophistication outside the banking sector, with the PFS Beneficiary countries showing very low levels of non-bank market development**.



Access to Financial Services

Access to financial services is limited in all of the PFS Beneficiary countries, although CEE SOUTHERN TIER has shown progress. Nonetheless, all three regions lag the Eurozone by a substantial margin.

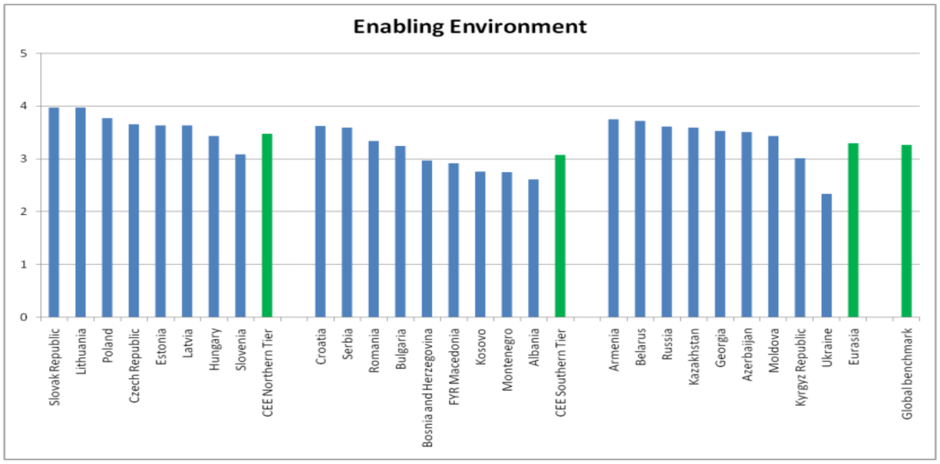
Access to financial services is lower in EURASIA (0.98 on a scale of 5.00) than in CEE SOUTHERN TIER (2.36) and CEE NORTHERN TIER (1.46). While its ATM density is superior to the other regions, EURASIA's access indicators reflect comparatively low borrower density and bank branch figures. Most importantly, real interest rate spreads have been volatile, making access less predictable. Negative real spreads through 2008 were unsustainable, and may have reflected a run-up in lending that culminated in a significant rise in non-performing loans resulting from the financial crisis (particularly in Ukraine). In this regard, access in EURASIA PFS Beneficiary countries (0.97) is similar to the norm for the region, and considerably less than access enjoyed by PFS Beneficiary countries in CEE SOUTHERN TIER (2.32).



The CEE NORTHERN TIER scores are influenced by the poor performance in Lithuania, Latvia and Hungary. Otherwise, these and SOUTHERN TIER countries are fairly comparable in terms of access to financial services, although for differing reasons. Both regions are similar in terms of bank branch and ATM density. However, CEE NORTHERN TIER countries have much higher borrower density ratios, reflecting considerably higher access to credit, whereas CEE SOUTHERN TIER countries had more reasonable and sustainable real interest rate spreads. PFS Beneficiary countries in the CEE SOUTHERN TIER had scores that were slightly lower than the regional average, mainly due to slightly lower bank branch and ATM density than in Bulgaria, Romania and Croatia.

Financial Sector Enabling Environment

The financial sector enabling environment measures show that PFS Beneficiary countries have made progress in some critically important areas for financial sector development. This reflects the gradual harmonization of reform objectives over the last two decades, while also reflecting continuing differences in systems.



The CEE SOUTHERN TIER region had the weakest scores (3.07 on a scale of 5.00), particularly among the PFS Beneficiary countries (2.89). Key weaknesses include the comparatively high number of procedures and amount of time required to register property and enforce contracts when disputes emerge. Contract enforcement costs are also high in the PFS Beneficiary countries. These indicators are linked, as excessive procedures culminate in slow processes, all of which undermine economic competitiveness and financial sector efficiency. The PFS Beneficiary countries of the CEE SOUTHERN TIER also lag the regional norm in terms of private credit bureau coverage, although their overall coverage rate is reasonably high when adding public credit registry coverage.

EURASIA PFS Beneficiary countries (3.38) scored nearly as high as the CEE NORTHERN TIER (3.48) due to reforms they have implemented in their property registration and contract enforcement processes. In all cases, EURASIA PFS Beneficiary countries scored reasonably well in terms of procedures, time required, and cost. However, the EURASIA continues to lag other regions in credit information coverage. Moreover, these scores do not include other issues that are limiting development of the economy and financial sector, such as corruption and the gray economy.

The CEE NORTHERN TIER had the highest scores overall (3.48), and its aggregate score was on par with global standards.

1.3. Potential Interventions to Support Sound Financial Sector Development

Financial Sector and Macroeconomic Stability

Financial stability efforts in the coming years should focus on the adoption and consistent implementation of international standards and best practices in the financial sector, by both regulatory authorities and financial sector participants. Despite years of effort, most PFS Beneficiary countries continue to face difficulties effectively implementing international standards for banking, capital markets, and insurance supervision. Many locally owned domestic financial institutions do not adhere to international accounting, auditing, and corporate governance standards. This reflects the growing complexity of international standards, and the limited institutional capacity and experience of financial sector regulators, professionals, and the industry at large.

Moving forward, implementation of international standards for the financial sector, combined with guidance from the Financial Stability Board, provide a medium- to long-term roadmap for reforms and actions that should be taken by PFS Beneficiary countries. Specific initiatives to strengthen financial stability, which can be adapted country by country, include:

- *Moving to balanced and appropriate levels of risk-weighted capital*, and developing capacity for forward-looking provisioning over time.
- *Sustaining regulatory and supervisory capacity-building, with emphasis on risk management techniques* to monitor systematically important institutions more intently, and further developing *protocols with foreign bank supervisors* for effective cross-border supervision.
- *Establishing specific bank resolution functions within regulatory agencies, and improving the legal environment for timely disposition of assets.*
- *Assisting with bank consolidation and privatization efforts, particularly in countries with large, interconnected, state-owned institutions.*
- *Redoubling efforts to enforce regulations for connected lending and large exposures.*
- *Assisting authorities with coordinated work-out strategies for non-performing loans*, including addressing obstacles to foreclosing on collateral, improving the veracity of asset valuations, and enhancing restructuring options.
- *Strengthening lenders' risk management systems* and risk evaluation capacity by establishing tools for more accurate market and accounting information, realistic collateral valuations, and mechanisms to ensure the enforceability of guarantees.

Financial stability is closely linked to macroeconomic stability, and vice-à-versa. While PFS may not be directly involved in macroeconomic policy issues, **PFS Beneficiary countries should nonetheless be encouraged to put emphasis on supporting a stable macroeconomic environment focused on stable and relatively low inflation rates, manageable fiscal deficits and indebtedness levels, adequate reserves to cover payment obligations, high levels of direct investment, and reasonable exchange rates to deter unsustainable current account deficits**. Initiatives that would be synergistic between macroeconomic and financial stability include:

- *Building stronger information and data collection, analytical capacity, and dissemination functions among market institutions (e.g. banks), central banks, and other regulatory bodies to determine* vulnerabilities via stress testing, scenario analysis and reporting.
- *Supporting technical work in liquidity management and market risk management* at financial institutions to reduce the risk that currency, interest rate or maturity mismatches could damage confidence in the banking system and general economy.

Financial Sector Size

As PFS financial systems are small, **it will take time for their banking and non-bank financial activity to deepen. To accelerate this, measures will need to be taken to instill confidence over the long term so that (1) depositors, creditors, investors and consumers feel safe, (2) their resources are prudently managed and protected, and (3) contractual obligations are understood and responsibly enforced**. Key priorities for growth could include:

- Developing strategies to diversify financial services, with specific targets set for achievement over a period of 10 or so years.
- Developing risk management capacity at banks focused on building quality credit portfolios, and managing asset quality problems when portfolio and market conditions deteriorate.
- For capital markets, promoting joint listings on established regional and global stock exchanges that would encourage more listings, increased transparency, greater investor confidence, and more freely floated shares that could be purchased on open market.
- Strengthening commercial court systems to ensure that contractual rights and responsibilities are observed and consistently enforced in a timely manner in banking, securities, insurance, and other financial services.
- For donor partners, conducting financial operations in local currency (to the extent possible) and through bank accounts or other forms of non-cash settlement for all in-country financial transactions (while managing risks associated with all financial services).

Financial Sector Sophistication

Financial sectors in the PFS Beneficiary countries are still relatively nascent in their development, with unsophisticated financial services. Banking sectors are limited in their lending and service offerings, and there is very little activity outside of banking. Initiatives to encourage greater financial sector sophistication include:

- Supporting regional capital markets integration, such as joint share indices and cross-listings.
- Developing government securities markets and establishing secondary markets for broader participation, back by focused support on sound debt management practices and development of a longer-term yield curve in local currencies.
- Providing incentives for long-term private savings (including life insurance) consistent with and supportive of initiatives taken in some countries with multi-pillar pension reform.
- Improving the business environment to encourage a competitive non-life insurance market (e.g., property and casualty, employment insurance, disability) to provide adequate protection for households and businesses, and to increase the supply of bankable customers or projects.
- Promoting non-life insurance products specific to protecting the value of pledged assets in secured lending transactions (e.g., vehicles, machinery, real-estate, crops, and other moveable property).

Access to Financial Services

There is limited access to financial services in the PFS Beneficiary countries, although delivery infrastructure for providing services (e.g., bank branches, ATMs, electronic payment systems) is improving. Efforts that could increase access to financial services include:

- Measures to support the development and use of internet-based banking and postal service outlets.
- Linking payroll systems with payment system infrastructure so that those with regular salaries can meet debt obligations regularly and electronically.
- Expanding coverage of credit transactions and histories by credit information bureaus so that credit can be structured and priced according to accurate and timely credit profiles.
- Developing property-related insurance products to enhance security.
- Introducing mechanisms via pledge and collateral registries that allow for faster and more efficient enforcement of collateral and guarantees in secured lending transactions.
- Introducing or expanding financial literacy and consumer protection education in financial services so that households and companies understand rights and responsibilities.
- Providing support, such as loan application assistance and credit counselling, to small-scale enterprises to meet banks' lending requirements and improve their financial statements.

Financial Sector Enabling Environment

The PFS Beneficiary countries have improved the business climate affecting financial sector and economic development, and progress needs to be sustained. However, there are also continued areas of weakness, including concerns about corruption, weak investor protection, and the general size of the informal sector. Information dissemination on borrowers, markets and trends are also weak, although many countries are showing progress in the area of credit information system coverage of borrowers. Initiatives that could improve the environment for the financial sector and broader economic development include:

- Promoting technical development and professional certification through distance learning for financial sector professionals (e.g., accountants, auditors, bankers, appraisers, actuaries), greatly facilitated by the internet and the fairly well established presence of banking institutes across PFS Beneficiary countries.
- Translating international accounting, auditing and financial reporting standards into local languages.
- Establishing policy reform committees involving business associations and regulators to work together to establish a sound regulatory framework for an improved business environment.
- Expanding the use of specialized commercial courts to reduce legal logjams.
- Expanding the use of user-friendly technologies to facilitate property registration.
- Developing and executing media campaigns promoting a responsible, honest civil service and bringing transparency to procedures and costs associated with business-related legal, regulatory and administrative requirements.

2. Introduction and Methodology

This Report has been produced with four major objectives:

- To briefly assess the consequences of the global financial crisis on the region;
- To evaluate ongoing disparities that persist across regions and countries;
- To provide data and analysis for USAID and others to better understand weaknesses and gaps in PFS markets; and
- To propose initiatives to USAID and others that might encourage better targeting of assistance to the region in support of financial stability and economic growth.

This Report provides an overview of key measures in the 12 PFS Beneficiary countries against comparable data found in other "transition" countries as well as more advanced economies. The "transition" economies are loosely defined as the countries covered by the EBRD (plus the Czech Republic). Advanced economies are generally presumed to be Eurozone, although for most of the key financial stability indicators, "advanced economies" include other countries outside the Eurozone that are members of the OECD. In certain cases, Korea is utilized as a proxy for advanced economies. Korea was specifically chosen because of its relatively recent emergence as an advanced economy, having also experienced hardship during the Asian financial crisis in 1998. Likewise, comparisons are also made with Turkey and Croatia as examples of non-OECD countries that are more advanced than the PFS Beneficiary countries, and whose performance in many areas can serve as targets for future development of the PFS Beneficiary countries over the next five to 10 years. Like Korea, Turkey has emerged in recent years after having experienced major financial crisis (in this case, more than once).

As noted in the *PFS Financial Sector Benchmarking System Development Plan*, high level benchmarking reports (including this Regional Report) focus on a summary of core indicators that address five broad themes. These themes are:

- ***Financial and macroeconomic stability*** (and soundness), to (1) evaluate the general underlying strength of the financial system and capacity to protect the economy and society from volatile swings in the economy; and (2) within the context of the macroeconomic environment, assess GDP growth, incomes, fiscal accounts, current account balances, debt profiles and foreign exchange reserves, and how these impact financial stability.

- ***Size of the financial sector/system***, to assess general levels of coverage and penetration, with focus on time series trends and how PFS Beneficiary countries are doing relative to peers and regional standards.

- ***Sophistication of the financial system***, to determine how responsive the financial system is to the needs of households, companies, and the economy as a whole, and how diverse the range of financial services is in support of savings and investment growth and long-term economic development.

- ***Access to financial services***, to determine degree of inclusion, general trends, and comparative performance in making affordable financial services available to households and the private sector along with those who have traditionally lacked access banking services.

- ***Transparency and the financial sector enabling environment***, to evaluate general measures of legal, regulatory, financial reporting and institutional capacity to facilitate or detract from economic growth and financial sector operations.

Global best practice benchmarks have mainly been taken from the Eurozone, although in some cases non-European countries have also been added (e.g., Financial Sector Stability), and in other cases, Korea has been utilized.

The indicators in the table below address the themes above. While not covering all issues and risks[3], the indicators capture the main areas of potential impact on financial stability. Key measures, components of those measures, and relative weights are as follows. (Zero weighted indicators represent topics covered in the report that are not weighted because of (1) questionable scoring relative to "facts on the ground" (e.g., Investor Protection index, Auditing and Accounting Standards, Access to Credit Index), (2) difficulties in getting adequate data (e.g., financial services to GDP), and/or (3) repetition (e.g., credit growth, since private sector credit growth and credit-to-GDP are weighted; nominal interest rates, since real interest rates are weighted).)

Table 1: Benchmarking Measures and Weights

Measures	Relevance	Weight
Financial Sector and Macroeconomic Stability		
Capital Adequacy Ratios	Identifies risks to individual bank solvency that can undermine confidence, safety/soundness, and trigger an event that can de-stabilize the financial system, economy and country	2
Non-Performing Loans as % of Total Loans	Permits tracking of credit quality relative to volume to reflect effectiveness of credit risk management systems	2
Provisions for Non-performing Loans as % of NPLs	Indicates degree of provisions set aside for problem loans as a measure of financial soundness	2
Return on Assets	Indicates returns relative to assets employed, and can provide scope for risk management during economic cycles as well as resources for build-up of counter-cyclical capital buffers	2
Deposit Growth	Indicates pace of deposit growth (or shrinkage) relative to broader economic trends	1
Credit Growth	Measure of potential asset bubbles based on unsustainable credit growth, and potential asset quality problems that can trigger events or a crisis	0
Private Sector Credit Growth	Measure of financial intermediation, and also point to potential asset bubbles based on unsustainable credit	1

[3] Many indicators that would enhance this review are not available from standardized or readily available sources. An effort has been made to gather consistently available information for important indicators and then use these to elaborate on themes associated with financial stability. This effort has been carried out in collaboration with USAID.

	growth and potential asset quality problems that can trigger events or a crisis	
GDP Growth Rates	Measure of overall economic output and potential degree of overheating	0
GDP per Capita	Measures living standards of the population and economic growth and progress over time	0
Inflation Rates	Measure of price stability with significant implications for the economy as a whole, monetary policy, bank rates and borrowing costs	2
Fiscal Balances/GDP	Indicator of general government capacity to intervene as needed for emergency financing, and to finance normal operating costs and needed investment	2
Current Account Balances/GDP	Reflects competitiveness as well as vulnerability, and points to future strengths and weaknesses of macroeconomic developments and financial stability	2
Gross Debt/GDP	Indicates magnitude of future payment obligations which has a direct impact on future competitiveness, incomes, and employment generation--includes domestic government debt and External debt	2
Gross Reserves/GDP	Measure of financial capacity to maintain sound ratings and negotiate more favorable conditions under stressed conditions, thereby directly related to economic, financial and political stability	2
Net Foreign Direct Investment/GDP	Measure of external confidence in economic and trade prospects, enterprise and market competitiveness, and general quality of the business environment	0
Foreign Exchange Loans/Total Loans	Indicates degree of market risk and investor confidence in the system, which can have a major impact on monetary policy, exchange rates, balance of payments, and sovereign debt ratings	1
Foreign Exchange Deposits/Total Deposits	Measure of public confidence in domestic currency and the banking system, potential volatility of capital flows, and exchange rate policy, all of which directly impact and reflect competitiveness	1
Loan-to-Deposit Ratios	Proxy for bank liquidity	1
Financial Sector Size		

Financial Services/GDP	Provides context for level (lack) of development of financial services relative to domestic economy, and a likely reflection on the breadth of coverage of financial services in the economy	0
Deposits/GDP	Cross-country comparative indicator to measure progress and potential gaps/weaknesses	1
Credit/GDP	Cross-country comparative indicator to measure progress and potential gaps/weaknesses	2
Capital/GDP	Serves as an indicator of general buffer against decline in asset values relative to obligations, and how this compares with overall economic output	2
Stock Market Capitalization/GDP	Indicator of listed company values as proxy for capital markets development	1
Insurance Premiums/GDP	Indicator of life and non-life insurance market penetration as a share of the overall economy	1
Sophistication of Financial Services		
Bond Market Trading Volume/GDP	Indicator of market liquidity, and investor confidence and activity for long-term investment by institutional investors	2
Stock Market Trading Volume/GDP	Indicator of market liquidity, and investor confidence and activity	1
Stock Market Capitalization/GDP	Indicator of listed company values as proxy for capital markets development	1
Life Insurance Premiums/GDP	Reflects instruments for long-term household savings (life), general public confidence in companies to manage long-term assets to ensure resources are available for claims coverage	1
Non-Life Insurance Premiums/GDP	Reflects degree of risk coverage for companies and individuals, often essential for loan transactions	1
Financial Market Sophistication	WEF index score reflecting opinion surveys	1
Access to Financial Services		
Nominal Interest Rate Spreads	Reflects cost of borrowing by the real sector from the banks on loans	0

Real Interest Rate Spreads	Reflects cost of borrowing by the real sector from the banks on loans accounting for inflation rates	2
Bank Borrower Density	Indicates number of bank borrowers as a share of the population	1
Commercial Bank Branch Density	Indicates availability of banking services to the retail market	1
ATM Density	Indicates availability of basic banking services to the retail market	1
Financial Sector Enabling Environment		
Cost of Property Registration	Useful indicator of public management of records for asset/collateral management and dispute resolution	2
Number of Property Registration Procedures		0.5
Property Registration Time Requirements		0.5
Cost of Contract Enforcement	Indicates efficiency and effectiveness of legal/administrative system regarding contractual disputes which reflects risk premium associated with credit/investment exposures and willingness of financial institutions to assume risk	2
Number of Contract Enforcement Procedures		0.5
Contract Enforcement Time Requirements		0.5
Getting Credit	Useful indicator of degree and types of credit information made available to creditors for the determination of loan origination and pricing	0
Public Credit Registry Coverage		1
Private Credit Bureau Coverage		1
Protecting Investors	Indicator of minority investor rights and protection	0
Strength of Auditing and Accounting Standards	Indicator of key information requirements needed for market and regulatory scrutiny of underlying financial condition of institutions, companies and systems	0

The above indicators and weighting system for scoring are intended to provide a broad overview and snapshot of how the subject countries currently fare in their performance on key financial sector themes. They are also intended to provide broad insights into relative stability or potential vulnerabilities, and to assist USAID (and other potential partners) in providing targeted support to the PFS Beneficiary countries to reduce future exposure to shocks or events that can destabilize economies and socio-political structures. However, the above indicators are limited in their scope, and do not presume to present a complete picture of potential risks or vulnerabilities. Rather, they constitute an effort to present a high-level summary of key strengths and weaknesses of country and regional performance based on comparisons with peer and other countries/regions.

The report uses spider charts to very broadly summarize regional profiles, as well as a series of other graphics in the main text to present trends based on key measures and indicators. The report also uses Text Boxes to highlight key points.

The methodology is designed to be broadly consistent with the general scoring or ranking system utilized by USAID/E&E Bureau based on a scale of "0" (worst) to "5" (best). However, there are differences, particularly in terms of the use of a sliding scale for country and regional scores rather than rigid cut-offs. (See Methodological Notes at the end of the report.) Key features are as follows:

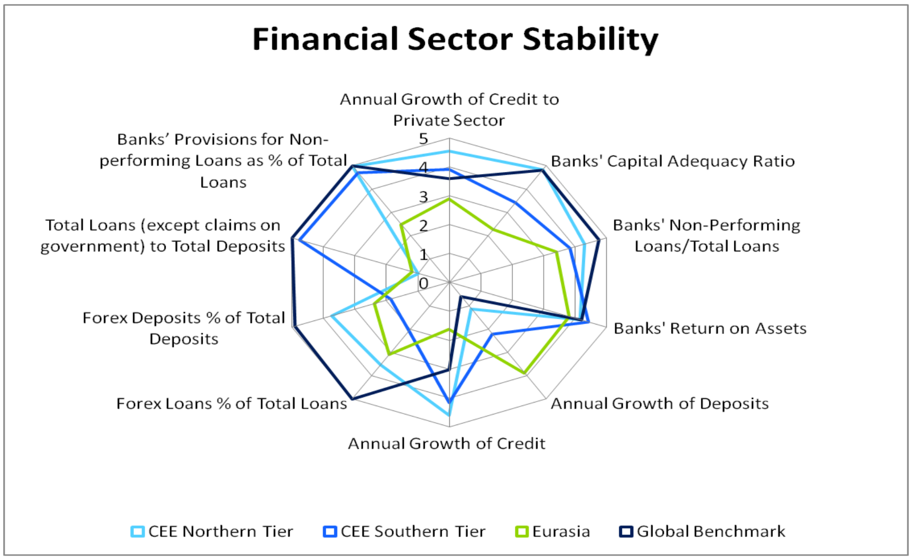
- Regional groupings are largely consistent with USAID groupings, as follows (with PFS Beneficiary countries in bold).
  - CEE NORTHERN TIER: Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, Slovenia.
  - CEE SOUTHERN TIER: **Albania, Bosnia**, Bulgaria, Croatia, **FYR Macedonia, Kosovo, Montenegro**, Romania, **Serbia**.
  - EURASIA[4]: **Armenia, Azerbaijan, Belarus, Georgia**, Kazakhstan, Kyrgyz Republic, **Moldova**, Russia, Tajikistan, Turkmenistan, **Ukraine**, Uzbekistan.
- Advanced economies are generally presumed to be Eurozone, although in the case of financial sector stability indicators also include non-Eurozone OECD countries.
- Regional averages are simple averages by country, and not weighted by measures such as GDP.
- Outliers have been excluded from regional averages.
- Most measures are percentages.
- The relevant range is set based on low-to-high parameters of the data set that serve as the base for establishing the distribution that provides the parameters for establishing scores based on a segmented distribution (e.g., based on quintiles).
- The country ranking is the score for the country by category that correlates with its position in the scale. Scores in between the highest ("5") and lowest ("0") are based on a sliding scale.
- The scores are based on a simple division of the relevant range into five separate categories to allow for a simple scoring of country performance against the performance of others. As the scale is based on quintiles, the scoring is a "0-5" system.
- In some cases, patterns are not linear. Therefore, where appropriate, bell curves have been utilized to establish scores.

[4] Mongolia is not a part of USAID's EURASIA group, but has been included in the statistics as part of the EBRD 29 and in some instances is referred to in the report.

3. Overview of Findings

3.1. Financial Sector and Macroeconomic Stability

General financial sector stability trends show the vulnerability of many economies to the recent global financial and economic turmoil. While some PFS Beneficiary countries have been less affected due to their limited links with and exposures to international capital markets, most face challenges regarding capital adequacy (e.g., excessively high levels to counter potential risks of default), rising non-performing loans, the need to increase provisions for non-performing loans, and a consequent decline in earnings as manifested in weak profitability (e.g., return on asset) measures. Other indicators show high levels of volatility in credit and deposit growth patterns, including contraction or negative growth in some cases. These are all intertwined with macroeconomic developments, particularly as this concerns (1) lending patterns in support of consumer purchases, and the impact this has had on current account balances, (2) competitiveness in export sectors, the impact this has had on reserves and exchange rates, and the consequent impact this has had on inflation rates, interest rates, and public confidence in local currency, and (3) how macroeconomic shocks, including disruptions in trade and investment, have culminated in declining loan quality and returns and, more recently, the availability of credit.



Significant reform has occurred over the years with legal and regulatory reform, institutional capacity-building with/for banking supervisors, bank restructuring and privatization, accounting reform, infrastructure development (e.g., property registration, credit bureaus), etc. A simple measure of progress is the conduct of banks, central banks and regulators in 2011 compared with their performance and approach to the market shortly after the collapse of the socialist system in 1989-90.

Key financial stability work that needs to be sustained or introduced includes better information, data, and coordination of analysis on vulnerabilities via stress testing, scenario analysis and reporting among market institutions (e.g., banks), regulators and central banks.

However, significant work remains to be done to protect financial institutions and the larger economy from the volatility and risks presented by a more open economy. Key financial stability work that needs to be sustained or introduced includes better information, data, and coordination of analysis on vulnerabilities via stress testing, scenario analysis and reporting among market institutions (e.g., banks), regulators and central banks. Additional work related to high level PFS themes includes (but is not restricted to):

- *Capital Adequacy*: PFS Beneficiary countries will need to focus on ensuring that banks and financial systems have adequate levels of common equity and Tier 1 capital to protect against adverse developments, along with increasing the overall level of capital banks and other financial institutions have. The presence in many of the PFS Beneficiary countries of EU-based banks can help significantly with the effort to stabilize the financial sector. However, as seen with some EU-based banks that have expanded into emerging markets over the last two decades, they have also faced solvency and liquidity challenges. Thus, in general, banks will require build-up of counter-cyclical capital buffers (meaning retaining earnings during highly profitable periods to prepare for when that cycle turns) and additional capital buffers for contingencies (unexpected events that trigger wholly unanticipated losses). Capital build-up will also require a ready market of investors willing to purchase shares, which will require better information from the issuer and the presence of investors willing to take positions in such institutions. This may also trigger consolidation among some banks/financial institutions, which will mean that regulatory/supervisory capacity needs to be in place, including protocols with foreign bank supervisors, to ensure that any systematically important institutions are properly overseen to avoid an event where such a comparatively large institution can weaken the system as a whole.

- *Non-Performing Loans*: The rise in non-performing loans (NPLs) across the globe has pointed to weaknesses in lenders' credit risk management systems, and this has been apparent in the PFS Beneficiary countries. Improved asset and portfolio quality requires enhanced credit risk evaluation capacity. This depends on better and more accurate market and accounting information to ensure borrowers have the cash flow to service and repay loans according to schedule under changing market conditions. For secured loans, collateral valuations backing loans are often inaccurate, particularly when accounting for business environment weaknesses related to the time and cost involved in repossessing and selling assets in loan recovery efforts. Likewise, domestic guarantees are often of questionable value. More broadly, the high levels of NPLs also have macroeconomic implications. They show an earlier willingness to lend to households and small businesses and pent-up demand for loans to finance private consumption. However, this also led to an overheating of the economy and a rise in current account deficits that were unsustainable. Banks will be tempted to recapture these markets as they emerge from the economic slowdown, so a recurrence of such trends will need to be monitored by the supervisory authorities and central banks to protect against volatile swings. In this regard, a stable macroeconomic environment supported by low or stable inflation rates, manageable indebtedness, adequate reserves to cover payment obligations, and high levels of direct investment will be essential in providing the conditions needed for a stable economy and, by extension, better asset quality.

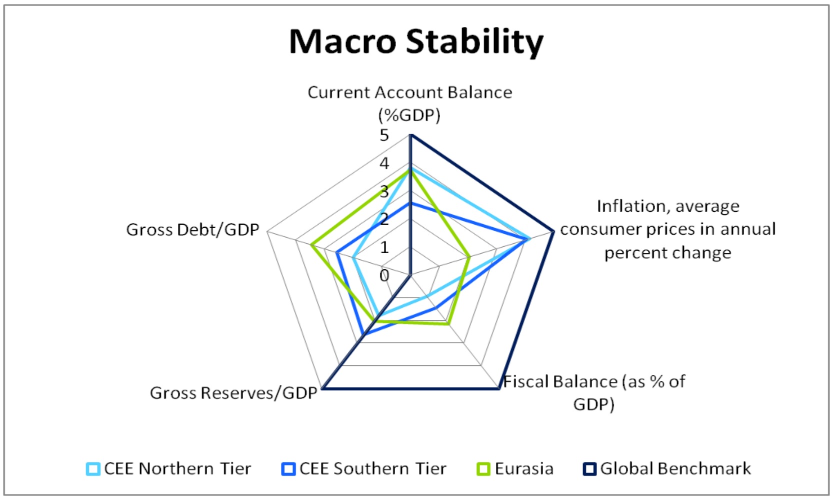
- *Provisions for Loan Losses*: Adequate provisioning is needed to ensure that capital buffers are in place to protect against unforeseen deterioration in the loan (and securities, investment and off-balance sheet) portfolio. Several of the PFS Beneficiary countries have shown some sluggishness in provisioning, while others may not have been as aggressive as they should have been. The practice of backward-looking practices will need to be modernized, particularly as provisioning under these circumstances often occurs too late. Forward-looking provisioning will need to be introduced, which will require more forward-looking scenarios about risk-taking and closer coordination between market players and regulators to conduct effective scenario analysis. This is closely related to lenders having better information, analytical capacity and risk management systems, including valid models to test risk scenarios so that they can assign probabilities to justify levels of provisioning. This will be a challenge to financial stability considering that many banks face the expensive challenge of investing in new systems and technologies and training their personnel while also attending to other capital needs. From a policy standpoint, any country that does not allow provisioning to be fully recognized as an operating expense should change this limitation to ensure that needed provisioning by banks is not avoided due to tax considerations.

- *Return on Assets*: Return on Assets (RoA) is often constrained because PFS Beneficiary country banks and other banking systems have limited earnings opportunities. These opportunities are often limited to traditional lending in sometimes difficult or risky business environments, or investing in government securities. Over time, RoA can increase as new instruments are introduced into the securities markets, new credit products and services are offered, and new lines of business are introduced. It is in the interest of broad financial stability that the financial sector be diversified and not unduly dependent on the banks. Likewise, it is beneficial if banks have multiple earnings sources for diversification purposes.

- *Credit and Deposits*: Efforts to promote prudent levels of credit growth, including to the private sector, depend on a multitude of factors. To the extent that credit is going to the private sector, the key for lenders is that borrowers be creditworthy, service their debts on time and in full, etc. However, it is also beneficial for securities markets to function, and for an adequate yield curve to be established in local currency so that problems of term funding can be addressed. As an example, absent a government securities market, including one that offers long-term bonds in local currency, it is difficult for banks to offer savings instruments that are suitably priced to attract long-term funds that can then be offered in the form of long-term mortgage products to households. Thus, credit growth needs to focus on the private sector, but a soundly managed public sector that floats securities in the domestic market for some of its financing needs is also helpful in developing, deepening and diversifying the financial sector. Likewise, the build-up of deposits from households and the corporate sector depends on the confidence that these entities have in the banks, as well as a general level of confidence in monetary policy as reflected in interest rates and exchange rates. Where there are high levels of exposure to currency risk, efforts will need to be made to contain exposure to unfavorable exchange rate movements and mismatches in bank portfolios. Likewise, where leverage ratios are high and banks face potential liquidity risk or timing mismatches, risk management systems will need to be in place to ensure these do not become problematic on a systemic basis. Broadly, efforts to support macroeconomic stability and sound public finances ultimately translate into a better environment for lending and investment to the private sector.

- *Loan-to-Deposit Ratios*: Loan-to-deposit ratios can serve as a basic proxy for potential liquidity or funding mismatches that can trigger serious refinancing and portfolio restructuring problems. In the absence of adequate refinancing mechanisms, this can become a major risk to lending institutions. First, deposits can easily be withdrawn. Thus, any run on a bank's deposits would require it to obtain compensating financing under stressed conditions, in all likelihood at a premium. Second, even with a stable deposit base, high levels of non-deposit borrowing are subject to market risks (e.g., currency, interest rate) that can trigger higher financing costs at a later date, particularly if loan exposures are long-term fixed and liabilities are shorter-term and subject to more frequent rate changes. Markets have responded over the years with hedges, indexation schemes, or just simple matching. PFS support might include technical work in asset-liability management and market risk management to ensure financial institutions do not create imprudent mismatches. Working with the central banks and regulatory agencies is important for monitoring of mismatches to contain risks that can trigger a liquidity crisis.

Much of this work will be heavily influenced by macroeconomic trends. Central banks and other authorities responsible for monetary policy have focused on inflation rates and price stability over the last two decades, with mixed effects on immediate economic challenges. Tightened monetary policy has been beneficial in helping to get inflation rates under control, but such tightening has also been associated in some cases with social dislocation, unemployment, reduced purchasing power, declines in industrial production, etc. Likewise, much of the challenge has been on achieving fiscal balance or sustainable deficits in combination with reduced inflation rates. However, in some cases, this has also added to a lack of financial resources in the real sector as well as for needed social infrastructure and support during transitional periods. Such pressures have sometimes led to a run-up of gross debt which, in the absence of competitive export industries and/or a reasonable fiscal base for revenues, has triggered challenges in terms of debt service requirements and levels of reserves. Meanwhile, pent-up demand for goods and services in a period of trade liberalization has translated into major current account deficits in many countries.



With regard to financial stability issues, the impact of the crisis has been negative in most cases, with particularly adverse impacts on loan quality and bank earnings, as reflected in rising non-performing loans, increasing provisioning requirements for realized (and in some cases, anticipated) loan losses, and declining return ratios. The crisis has also triggered calls by central banks and regulatory authorities for banks to increase capital, particularly in light of the heightened risks in regional and global trends and the insufficient weights applied in risk-based calculations to many of the exposures banks have on and off their balance sheets.

As competitiveness takes years or decades to achieve, policies need to account for the time and resource cover required to meet targets and objectives. This is particularly challenging in economies where exchange rates are pegged or tied, the fiscal base is weak, export earnings are constrained or vulnerable, operational efficiency is low, and research, education and skill levels are relatively low.

The reform agenda will need to continue to address these issues in an effort to ensure a stable environment for sustainable long-term growth. As competitiveness takes years or decades to achieve, policies need to account for the time and resource cover required to meet targets and objectives. This is particularly challenging in economies where exchange rates are pegged or tied, the fiscal base is weak, export earnings are constrained or vulnerable, operational efficiency is low, and research, education and skill levels are relatively low. Additional work in PFS Beneficiary countries will need to include the following:

- *Inflation Rates*: Continued support for inflation targeting and price stability will be essential for stabilizing interest rates and exchange rates. This will provide investors with greater certainty that will permit a gradual broadening and deepening of financial services which, in turn, will facilitate enhanced savings and investment options for households and businesses. Depending on the country, specific initiatives might focus on enhanced statistical capacity and data collection, and better use of such data and information to address areas of potential vulnerability to the economy and financial sector. These needs appear to be particularly acute in EURASIA.

- *Fiscal Balances*: Despite ongoing challenges at the structural level, PFS Beneficiary countries will gradually need to expand their fiscal base to be able to provide meaningful services and infrastructure investment. Most countries have done a good job of keeping deficits within reasonable ranges. Initiatives in this area could focus on medium- to long-term planning for education (at all levels, including vocational), social insurance, health care (including preventive measures), and high-priority infrastructure requirements. Much of this can come from public-private initiatives. A major contribution in building confidence in the public sector is efficient service delivery, often a weakness in PFS Beneficiary countries. Therefore, institutional capacity-building efforts in the legal and regulatory environment, including improvements in the general business environment regarding property registration, contract enforcement, investor protection, etc., can help to reduce potential blockage in the system and allow for better use of public funds for meaningful service delivery. Improvements in these areas tend to reduce overall risk in the business environment, thereby reducing the overall risk premium on loans and other financial products.

- *Current Account Balances*: Deep current accounts in the PFS Beneficiary countries are symptomatic of pent-up demand along with competitiveness challenges. In the case of the former, this partly reflects demand for higher quality goods and services at both the household and enterprise level. To the extent that deficits are transitory and reflect outlays for plant and equipment that can enhance competitiveness, this is a positive development. However, much of the imbalance is in the household consumer goods sector, which provides limited multiplier effect or benefits to domestic economies. Thus, the imbalances will shift over time only as the PFS Beneficiary countries are able to diversify and deepen their export potential while also keeping consumer goods expenditures within reasonable limits. This may be partly mediated by the banking sector, and links back to banks making profitable loans to investments that generate sound cash flow for debt servicing needs.

- *Debt Management*: Most PFS Beneficiary countries have managed to keep their debt profiles within manageable levels, partly due to the weak private market for much of their debt combined with strict standards required by the IMF and other creditors. Over time, the volume of debt as well as the interest rates paid on such debt will largely reflect anticipated future payment performance, all of which will depend on macroeconomic balances and trends. Thus, appropriate debt management will require stable macroeconomic fundamentals across the board.

- *Reserves*: Gross reserves are essential for debt service, critical imports and emergencies, and to demonstrate resources exist for future borrowing needs. This relates back to the importance of export competitiveness and the ability to accumulate reserves. Remittance flows, portfolio investment, and other current transfers can help on a short-term basis, but long-term confidence depends on meeting minimum targets for reserves. Assistance to PFS Beneficiary countries, particularly those in EURASIA that are not overly endowed with highly valued commodities, could target strategies and targets for reserve accumulation.

The following table provides a brief snapshot of key financial and macroeconomic stability trends in recent years and how these point to ongoing gaps and challenges in the PFS Beneficiary countries. (Scores are based on a "0" to "5" scale, with "5" being the highest. Global measures are generally Eurozone. NORTHERN, SOUTHERN and EURASIA represent USAID groupings. "SEE-PFS" and "EUR-PFS" represent the 12 PFS Beneficiary countries by specific region. Greater detail is provided in the Methodology section at the end of the report.)

Table 2: Financial Sector and Macroeconomic Stability[5]

Indicator	Global	NORTHERN	SOUTHERN	SEE-PFS	EURASIA	EUR-PFS
			Financial Sector Stability			
Score	3.69	3.94	3.67	3.51	2.79	2.89
Capital Adequacy	Rising and reasonably stable since 2008; 13.1% average	Rising since 2008; 12.9% average	High and increased in 2010; 17.1% average	High and reasonably stable; 17.6% average	Very high; 20.7% average	Very high; 24.6% average
Non-performing Loans	Rising since 2008 from reasonably low and stable levels; 3.3% average	Very high since 2009; 5.7% average	Very high since 2009; 8.1% average	Very high since 2009; 8.6% average	Very high since 2009; 10.3% average	Very high since 2009; 10.2% average
Provisions for Loan Losses	Reasonable coverage; 69.6% average	Reasonable coverage; 69.5% average	Reasonable coverage; 73.5% average	Reasonable coverage; 79.0% average	Matched (full) coverage; 99.3% average	Reasonable coverage; 83.8% average
Return on Assets	Low but positive; 0.5% average	Negative in 2009 and flat in 2010; 0.4% average	Low since 2009, but higher before; 1.0% average	Low since 2009, but higher before; 0.9% average	Negative since 2009[6]; negative 0.5% average	Reasonable except for losses in 2009; 1.0% average
Credit	Slow since 2008 and	Negative in 2009;	Slow in 2009; 27.0%	Slow in 2009; 28.2%	Reasonable growth;	Reasonable growth;

[5] The general discussion of "stability" links financial sector and macroeconomic issues. However, given the importance of the subsets relative to other measures incorporated into the scoring system, the two areas have been disaggregated for purposes of scoring and evaluation of findings.

[6] This measure may be distorted due to Kazakhstan's performance in 2009-10.

Growth	almost flat in 2009; 7.4% average	17.7% average	average	average	40.6% average	41.3% growth
Private Sector Credit Growth	Slow since 2008 and almost flat in 2009; 7.4% average[7]	Negative in 2009; 15.2% average	Slow but still positive in 2009; 29.7% average	Slow but still positive in 2009; 31.55 average	Reasonable growth; 36.1% average	Reasonable growth; 41.1% average
Deposit Growth	Flat in 2009; 8.4% average	Slowdown in growth in 2009; 11.2% average	Significantly lower growth since 2008; 17.1% average	Significantly lower growth since 2008; 18.2% average	High growth; 26.2% average	High growth; 25.9% average
Foreign Exchange Loan Exposure	About half, therefore fairly high; 53.4% average	Relatively low; 21.2% average	Nearly half, therefore fairly high; 43.2% average	About one third; 35.7% average	Less than one third; 30.7% average	One third; 33.5% average
Foreign Exchange Deposit Share	Low[8]; 9.1% average	Stable share; 25.9% average	About half; 52.6% average	High share; 59.1% average	High share; 53.4% average	Very high; 55.3% average
Loans-to-Deposits	Very high (1.7x)	Very high (1.6x)	Reasonably balanced (1.1x)	Reasonably balanced (1.1x)	Very high (1.6x)	Very high (1.6x)
Macroeconomic Stability						
Score	2.79	2.43	2.60	2.55	2.98	2.58
Inflation	Low and stable; 2% average	Low since 2009, but fairly high before then; >4%	Low and stable in 2007 and since 2009; 4.5% average	Low and stable in 2007 and since 2009; >4% average	High in 2007-08, lower since; 10% average	High in 2007-08, lower since; 10% average

[7] May actually be slightly lower, as statistics in the Eurozone do not separate credit to the private sector from credit to public enterprises.

[8] In this case, the global benchmark utilized is Korea.

		average				
Fiscal Balances	Fairly high deficits; 3.9% average	Fairly high deficits; 4.2% average	Reasonable deficits; 2.8% average	Reasonable deficits; 2.9% average	Low deficits; 1.0% average	Reasonable deficits; 2.9% average
Current Account	Low deficits; 2.5% average	Surpluses since 2009 after deep deficits in 2007-08; <4% average	Very high deficits, although some improvement since 2009; nearly 14% average	Very high deficits, although some improvement since 2009; 15.5% average	Comparatively low and stable deficits; 4.5% average[9]	High deficits, although some improvement since 2009; nearly 11% average
Gross Debt	Very high; 180.3% average	High; 131.4% average	Moderately high; 97.4% average	Moderately high; 93.6% average	Reasonably low; 67.0% average	Reasonably low; 71.9% average
Gross Reserves	High[10]; 26.3% average	Low to medium levels; 18.3% avg.	Reasonably high levels; 23.3% average	Medium levels; 21.3% average	Low to medium levels; 19.7% average	Low; 17.0% average

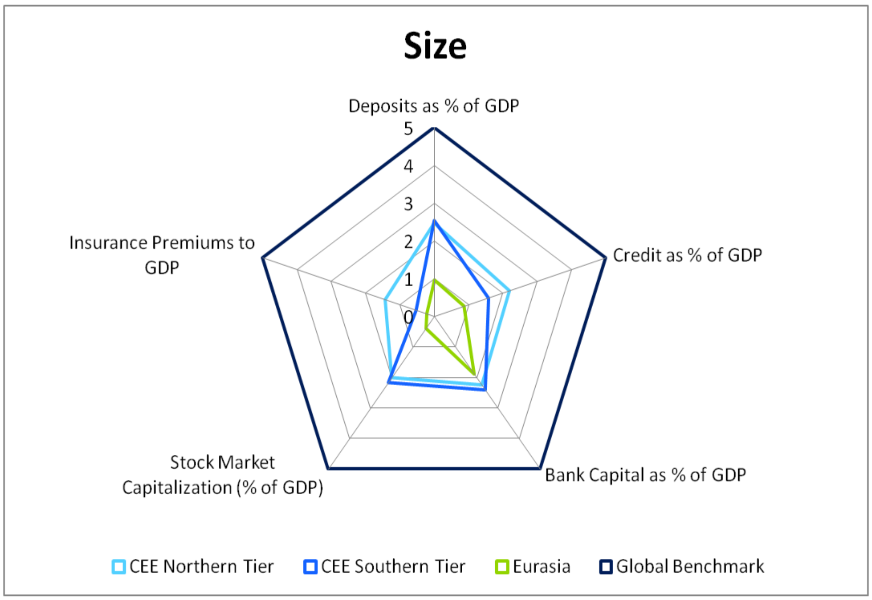
[9] Surpluses in Azerbaijan have been excluded as an outlier. However, several EURASIA countries are resource-rich in commodities that have generated current account surpluses. Including Azerbaijan's high surpluses would bring this average current account deficit for the region down substantially.

[10] Korea is used as the global benchmark.

3.2. Financial Sector Size

Most countries for which data are available seem to show about 3-5 percent of GDP is accounted for by financial services. However, the size of the financial sector in many of the countries under review, including several PFS Beneficiary countries, is difficult to measure due to weak data on non-banking sectors. In most cases, CEE NORTHERN TIER has a larger financial sector than the other regions, particularly in terms of bank credit penetration. However, its deposit mobilization relative to GDP has actually been slightly lower than in CEE SOUTHERN TIER for 2007-09, and bank capital to GDP is actually highest in the Central Asian countries of EURASIA.

Efforts to increase the size of the financial sector extend from stability measures for confidence and certainty, capitalization for protection against unexpected events, diversification of activities for a broader range of earnings sources, and effective risk management to ensure stability. However, while needed a sound financial sector foundation is not sufficient to create a competitive economy. Adequate financing combined with strong management and operations are also required at the firm level to ensure competitiveness and creditworthiness.



While some banks have grown in the countries under review, there are still many banks that remain comparatively small and at a competitive disadvantage. This is true with regard to resources needed for ongoing investment and training, particularly in smaller markets where they may need to diversify to add to the limited number of earnings opportunities available in the domestic market.

Some of the increase in banking assets that has occurred is the result of strategic investment by foreign banks, which has helped to improve systems and product development, increase capital, enhance risk management, etc. However, this also poses a challenge to PFS Beneficiary countries when foreign banks account for a major share of the domestic market, and are under tight control from headquarters, faced with limitations on liquidity, credit exposures, etc.

Efforts to increase the size of the financial sector extend from the points noted above in terms of stability measures for confidence and certainty, capitalization for protection against unexpected events, diversification of activities for a broader range of earnings sources, and effective risk management to ensure stability. However, while needed, a sound financial sector foundation is not sufficient to create a competitive economy. Adequate financing combined with strong management and operations are required at the firm level to ensure competitiveness and creditworthiness. As more businesses achieve this, the financial market should increase its product/service offerings and be creative with pricing. Likewise, as households see a rise in incomes, a whole range of consumer products should be available in the market for households to benefit from new wealth.

These developments have already occurred in the last decade and will continue, as evidenced by the presence of ATMs, credit cards, mortgage loans, auto loans, etc. However, in light of recent developments, future consumer and mortgage lending will also need to account for interest rate uncertainty and swings in household incomes under volatile circumstances, particularly when jobs are not always secure. Likewise, small business lending will need to account for a range of potential financial, operational and managerial limitations. Specific approaches to increase financial sector size could include:

- *Financial Services to GDP*: A strategy to diversify financial services is warranted, with specific targets set for achievement over a period of 10 or so years. Targets can be in the aggregate, as well as by financial sub-sector. Targets can also be based on per capita figures, such as a specified amount of financial services per capita, measured against performance in other peer countries.

- *Deposits to GDP*: While economic growth has slowed in the PFS Beneficiary countries and throughout the region, many countries have shown success in continuing to mobilize deposits under trying circumstances. PFS Beneficiary countries can set a timeline to try to match the Eurozone level by a certain date, or a percentage of that rate, as a benchmark for performance. Maintaining stability is key to confidence, which is indispensable for depositors placing funds with banks. Offering new products at competitive rates is another way for banks to increase deposits. However, many institutions shy away from mobilizing more deposits because of their view that they constitute surplus liquidity due to the limited lending and investment options. So the motivation to sustain deposit growth is also linked to how these funds can be intermediated.

- *Credit to GDP*: The challenge here is risk management capacity to ensure quality. This is partly linked to the macro-economy, and partly to the competitiveness and efficiency of the borrower. These ultimately combine to determine the creditworthiness of the borrower and the soundness of the loan transaction. Thus, the fundamentals for stability and diversification under competitive conditions will drive this. The level of credit to GDP is less important than the level of performing credit to GDP. Therefore, this is a volume and quality issue. Nonetheless, accounting for quality requirements, PFS Beneficiary countries can try to set targets that would be linked to other targets related to lower levels of NPLs. Such an approach is not altogether different from banks that set their risk tolerances in asset allocation strategies.

- *Bank Capital to GDP*: Higher ratios of bank capital to GDP are usually a positive development for economies and banking systems. Setting bank ‘capital to GDP’ targets could be a useful exercise, although this would also need to be linked to projections of asset growth and suitable risk weighting. Any targets for growth would need to be linked to future assumptions about capital adequacy, while asset growth would need to be consistent with quality considerations governing credit growth.

- *Stock Market Capitalization to GDP*: CEE NORTHERN TIER countries have shown development of an equities market in recent decades. However, given the myriad problems of the markets and general business environment, combined with the small size of many of these markets, stock markets have not taken off in any region. It is uncertain if they can take off in the smaller countries without some form of joint listings on larger exchanges. In the larger countries and economies, stock markets often need more listings, more transparency, more investor confidence, and more free float.

- *Insurance Premium Revenues to GDP*: Gross insurance premiums approximate 2 percent of GDP in the three regions under review based on available and limited data. On a regional basis, CEE NORTHERN TIER showed 2.9 percent in 2009, followed by CEE SOUTHERN TIER (2.2 percent) and EURASIA (1.8 percent). However, the averages in the last two regions would decline if averaged with the 15 countries for which data were not readily available, but whose penetration ratios are generally thought to be at or below 0.5 percent. This shows very limited development of the insurance market.

The following table provides a brief snapshot of financial sector size and how this relates to ongoing gaps and challenges in the PFS Beneficiary countries.

Table 3: Financial Sector Size

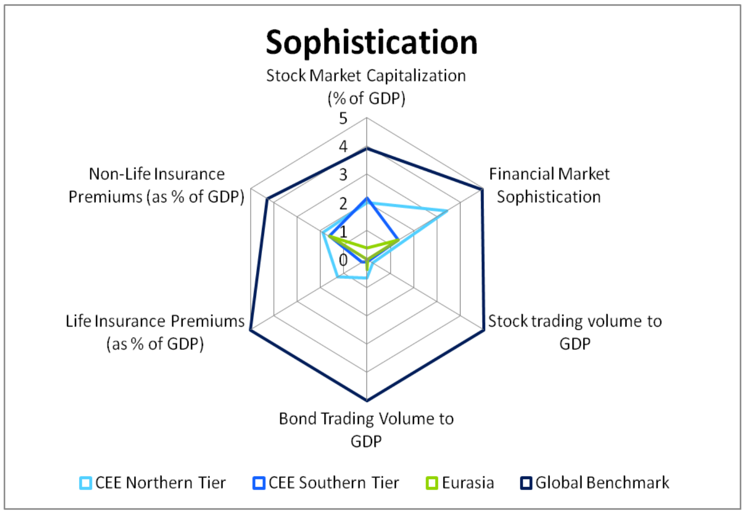
Indicator	Global	NORTHERN	SOUTHERN	SEE-PFS	EURASIA	EUR-PFS
Score	4.56	2.11	1.89	1.70	1.01	0.83
Deposits to GDP	High levels; 82.9% average	Moderate levels; 46.7% average	Moderate levels; 47.8% average	Moderate levels; 46.0% average	Low levels; 25.0% average	Low levels; 23.4% average
Credit to GDP	High levels; 139.8% average	Moderately high levels; 72.4% average	Moderate levels; 57.6% average	Moderate levels; 54.4% average	Relatively low levels; 40.4% average	Relatively low levels; 37.1% average
Bank Capital to GDP	High levels; 16.6% average	Moderate levels; 11.1% average	Moderate levels; 11.6% average	Moderate levels; 11.3% average	Relatively low levels; 10.0% average	Low levels; 9.0% average
Stock Market Capitalization to GDP[11]	High levels; 53.4% average	Moderately low levels; 27.3% average	Moderately low levels; 29.4% average	Moderately low levels; 24.5% average	Very low levels; 5.5% average	Very low levels; 1.5% average
Insurance Premiums to GDP[12]	Very high levels; 19.6% average	Low levels; 3.2% average	Low levels; 2.6% average	Low levels; 3.1% average	Very low levels; 1.9% average	Low levels; 2.5% average

[11] As per the text, stock market capitalization figures are not always accurate. Thus, it is conceivable that the variance of regional averages with Global measures is larger than presented.

[12] Data only available for 17 countries. This means that the actual averages for all but Global measures are lower. The database only includes 89 countries with insurance premiums at or above 1 percent of GDP. Thus, countries for which data are missing would bring down the averages, particularly in the SEE and EURASIA regions.

3.3. Sophistication of Financial Services

Apart from banking, most CEE SOUTHERN TIER and EURASIA markets have shown limited financial sector development. There are some exceptions in the securities markets, as a handful of countries have shown reasonable levels of stock market capitalization and turnover, albeit less so after 2007.



CEE NORTHERN TIER is the only region where the non-bank financial sector has shown initial stages of progress in building diversified financial services. However, even here, there has been limited development to date in the capital markets and insurance market. In general, when evaluating bond trading volume, stock market capitalization, and stock market trading volume, the data reflect a general lack of development in the securities markets.

Developing these markets will take time. Of critical importance is developing the insurance sector, not only for the protections it can offer in the non-life sector, but as an institutional investor with long-term investment needs for its life insurance contracts. This is related to the nature of long-term savings for retirement, social insurance, and pension fund systems, all of which relate back to public finance considerations (e.g., taxation, interest rates, bond prices and yields).

Absent institutional investors, it is difficult to develop a securities market unless retail investors have significant sums of cash, which is usually is not the case[13]. In addition to cash, investors need to have trust in the securities in which they invest. Given that most companies are tightly controlled, there is little opportunity in the equities market unless an investor has full or majority control. The limited free float in the market undermines liquidity and pricing. Likewise, because governments, financial institutions and corporate entities have floated limited numbers of bonds in domestic markets, it is difficult to push capital markets development under existing circumstances.

Support to increase financial sophistication can include:

- ***Development of a regional stock exchange and joint listings.***
- ***Development of a government securities market.***
- ***Incentives for long-term private savings.***
- ***An improved environment to encourage a competitive non-life insurance market.***

Support to increase financial sophistication can include:

- Supporting development of a regional stock exchange, or at least cross-listings.
- Developing a government securities market focused on sound debt management practices, but aspiring to develop a long-term yield curve in local currency.
- Providing incentives for long-term private savings (including life insurance) consistent with initiatives taken in some countries with multi-pillar pension reform.

[13] Even in resource-rich countries that benefit from swings in commodity prices, income distribution patterns tend to show concentrations of wealth that are often invested outside the country, rather than broad distribution that narrows GINI coefficients and triggers widespread retail investment in domestic securities markets.

- Improving the business environment to encourage a competitive non-life insurance market (e.g., property and casualty, unemployment insurance, disability) to provide adequate protections and coverage for households and businesses within a framework that protects against fraud on the one hand, and ensures reasonable consumer protection against unfair claims denial on the other.

The following table provides a brief snapshot of financial sector sophistication and how this relates to ongoing gaps and challenges in the PFS Beneficiary countries.

Table 4: Financial Sector Sophistication

Indicator	**Global**	**NORTHERN**	**SOUTHERN**	**SEE-PFS**	**EURASIA**	**EUR-PFS**
Score	4.67	1.42	0.89	0.54	0.70	0.56
Bond Trading Volume to GDP[14]	Moderately high levels; 40.2% average	Very low levels; 5.4% average	Very low levels; 0.9% average	Very low levels; 0.2% average	Very low levels; 3.1% average	Very low levels; 4.9% average
Stock Market Capitalization to GDP[15]	High levels; 53.4% average	Moderately low levels; 27.3% average	Moderately low levels; 29.4% average	Moderately low levels; 24.5% average	Very low levels; 5.5% average	Very low levels; 1.5% average
Stock Trading Volume to GDP[16]	High levels; 177.4% average	Very low levels; 9.0% average	Very low levels; 3.6% average	Very low levels; 3.0% average	Very low levels; 1.0% average	Very low levels; 0.5% average
Life Insurance Premiums to GDP	Reasonably high levels; 4.6% average	Moderately low levels; 1.2% average	Low levels; 0.2% average	No real market	No real market; 0.02% average	No real market; 0.02% average
Non-Life Insurance Premiums to GDP[17]	Reasonably high levels; 3.4% average	Moderate levels; 2.0% average	Moderate levels; 1.9% average	No real market	Moderate levels; 1.8% average	Moderate levels; 2.3% average

[14] Korea is the Global benchmark for this data set.

[15] As per the text, stock market capitalization figures are not always accurate. Thus, it is conceivable that the variance of regional averages with Global measures is larger than presented.

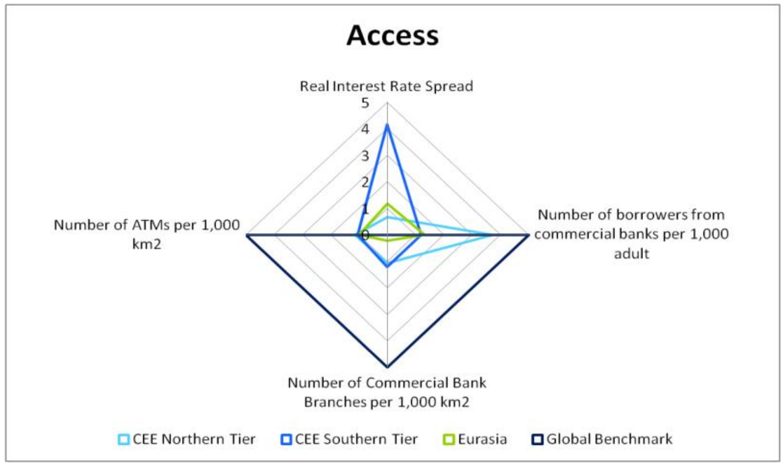
[16] Korea is the Global benchmark for this data set.

[17] Data only available for 17 countries. This means that the actual averages for all but Global measures are lower. The database only includes 89 countries with insurance premiums at or above 1 percent of GDP. Thus, countries for which data are missing would bring down the averages, particularly in the SEE and EURASIA regions.

Financial Market Sophistication Index[18]	Very high levels; 5.5 average on a scale of 7	Reasonably high levels; 4.6 average on a scale of 7	Moderate to low levels; 3.3 average on a scale of 7	Moderate to low levels; 3.1 average on a scale of 7	Moderate to low levels; 3.3 average on a scale of 7	Moderate to low levels; 3.4 average on a scale of 7

3.4. Access to Financial Services

Access to financial services has shown variable patterns across regions based on interest rates (affordability), credit availability, and the availability and proximity of infrastructure. Rate patterns have differed across regions, as has the response to the economic slowdown. In some PFS Beneficiary countries, the economy was overheated before the crisis and needed a correction. In other cases, interest rates have come down in real terms, even if credit conditions have tightened. As for infrastructure, several countries have invested in branches and ATMs, although most financial services tend to be concentrated in the largest population centers, for obvious reasons, without high levels of innovation or risk-taking being evident in other areas.



Efforts that may support increased access include:

- ***Increased provision and use of internet-based banking.***
- ***Expanded integration of payroll systems with loan payment system infrastructure.***
- ***Expanded coverage of credit transactions and histories by credit information bureaus.***
- ***Clear and automatic enforcement for collateral and guarantees securing loans.***
- ***Financial literacy training.***
- ***Business loan application outreach.***
- ***Development of the non-life insurance sector.***

Access has improved in the last decade, even though borrower density statistics are low in several PFS Beneficiary countries. However, increased access is linked to many of the other observations and recommended initiatives described above. This includes rising household incomes and enterprise competitiveness to enhance creditworthiness, a stable macro-economy so that rates and spreads are reasonably balanced for lenders and borrowers, adequate levels of competitiveness among financial institutions so that they are actively seeking new customers, and diversification of financial services so that specific needs can be accommodated by reasonably specialized institutions (or specialized units of diversified banks or other financial institutions).

Efforts that may support increased access to financial services include:

- Increasing provision and use of internet-based banking and postal service outlets.

[18] The range of scores on this is index is "2"-"7", with 7 being the most sophisticated.

- Linking company payroll systems with loan payment system infrastructure so that those with regular salaries can meet their debt obligations regularly and electronically.
- Expanding coverage of credit transactions and histories by credit information bureaus so that credit can be structured and priced according to positive information as well as account for negative information.
- Introducing mechanisms via pledge and collateral registries that allow for clear and automatic enforcement of collateral and guarantees securing loans.
- Introducing or expanding financial literacy training so that households and companies understand rights and responsibilities and can plan for these obligations.
- Providing loan application assistance and credit counselling to small-scale enterprises so that their financial information provided to lenders addresses lenders' credit origination and underwriting requirements for a loan.
- Developing property-related insurance products so that lenders are comfortable with insurance protections offered on the assets securing collateralized loans.

The following table provides a brief snapshot of access to financial services and how this relates to ongoing gaps and challenges in the PFS Beneficiary countries.

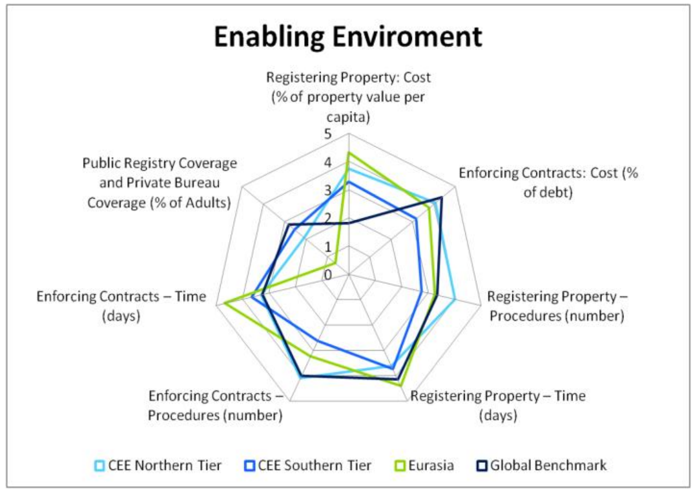
Table 5: Access to Financial Services

Indicator	**Global**	**NORTHERN**	**SOUTHERN**	**SEE-PFS**	**EURASIA**	**EUR-PFS**
Score	5.00	1.46	2.36	2.32	0.98	0.97
Real Interest Rate Spreads	Narrow spreads that were negative in 2008; 0.4% average	Negative net spreads, although positive in 2009; negative 2.2% average	Positive and reasonable spreads; 1.4% average	Positive and reasonable spreads; 1.7% average	Negative net spreads, although positive in 2009; negative 1.1% average	Negative net spreads, although positive in 2009; negative 2.1% average
Borrower Density[19]	High levels; 572 on average	Reasonably high levels; 430 on average	Low levels; 153 on average	Low levels; 153 on average	Low levels; 164 on average	Low levels; 177 on average
Bank Branch Density	High levels; 92 on average	Moderate to low levels; 20 on average	Moderate to low levels; 23 on average	Moderate to low levels; 16 on average	Low levels; 5 on average	Low levels; 6 on average
ATM Density	High levels; 155 on	Moderate to low	Moderate to low levels;	Moderate to low levels;	Moderate to low levels; 32	Moderate levels; 46 on

[19] Data only available for 12 countries, of which 7 are PFS.

	average	levels; 36 on average	33 on average	24 on average	on average	average

3.5. Financial Sector Enabling Environment



The business environment for financial sector development shows improvements are needed in many areas of the financial sector enabling environment, although positive trends since 2007 are also evident. Property registration and contract enforcement are often time-consuming in PFS Beneficiary countries, credit information is not always available for loan decision-making, investor protection is weak in many of the PFS Beneficiary countries, and auditing and accounting standards are also weak in several of the PFS Beneficiary countries. More positively, there have been improvements reported across the board, and there seems to be recognition of the need to improve the environment for the financial sector to develop and diversify.

Methods to accelerate improvements in the financial sector enabling environment include (but are not restricted to):

- ***Promoting professional development and certification.***
- ***Working to arrange for translations into local languages of newly introduced accounting, auditing and financial reporting standards.***
- ***Establishing policy reform committees involving business associations and regulators for a favorable business environment and investment climate.***
- ***Increasing use of specialized commercial courts to reduce legal logjams.***
- ***Increasing use of user-friendly technologies to facilitate property registration.***

Many of these outstanding issues are longstanding and relate to the difficulties associated with transforming legal/judicial systems, restructuring bureaucracies, introducing new technologies that are user-friendly, or just the need for long-term training for adequate capacity (as in the case of audit and accounting) and systems integration (as in the case of many small banks).

Methods to accelerate improvements in the financial sector enabling environment include (but are not restricted to):

- Promoting professional development and certification through distance learning for financial sector professionals (e.g., accountants, auditors, bankers, appraisers, actuaries), greatly facilitated by the internet.
- Translating international accounting, auditing and financial reporting standards into local languages.
- Establishing policy reform committees involving business associations and regulators to work together to establish a sound regulatory framework for an improved environment.
- Expanding the use of specialized commercial courts to reduce legal logjams.
- Expanding the use of user-friendly technologies to facilitate property registration.

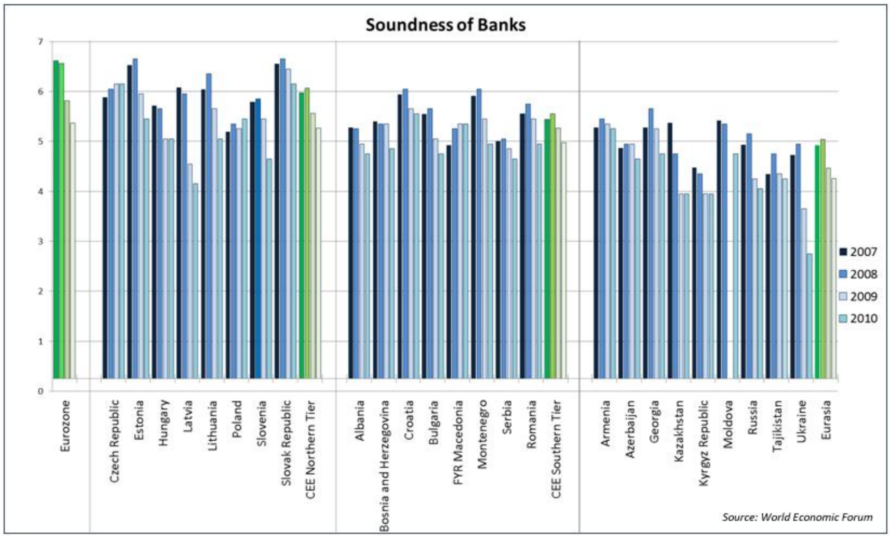
The following table provides a brief snapshot of the business environment for financial (and real) sector development and how this relates to ongoing gaps and challenges in the PFS Beneficiary countries.

Table 6: Financial Sector Enabling Environment

Indicator	**Global**	**NORTHERN**	**SOUTHERN**	**SEE-PFS**	**EURASIA**	**EUR-PFS**
Score	3.27	3.48	3.07	2.89	3.30	3.38
Property Registration Procedures	Moderate number of procedures; 5.4 in 2010	Low number of procedures; 4.4 in 2010	High number of procedures; 6.7 in 2010	High number of procedures; 6.5 in 2010	Moderate number of procedures; 5.3 in 2010	Low number of procedures; 4.3 in 2010
Property Registration Time	Relatively fast; 34 days in 2010	Relatively slow; 51 days in 2010	Relatively slow; 55 days in 2010	Relatively slow; 55 days in 2010	Relatively fast; 33 days in 2010	Relatively fast; 26 days in 2010
Property Registration Cost	Relatively high cost; 6.6% of property value per capita	Relatively low cost; 1.9% of property value per capita	Moderate cost; 3.1% of property value per capita	Moderate cost; 3.1% of property value per capita	Relatively low cost; 1.4% of property value per capita	Low cost; 0.9% of property value per capita
Contract Enforcement Procedures	Low number of procedures; 32 in 2010	Low number of procedures; 32 in 2010	High number of procedures; 40 in 2010	High number of procedures; 42 in 2010	Moderate number of procedures; 36 in 2010	Moderate number of procedures; 36 in 2010
Contract Enforcement Time	Relatively slow; 608 days in 2010	Relatively slow; 588 days in 2010	Relatively slow; 513 days in 2010	Moderately slow; 493 days in 2010	Relatively fast; 310 days in 2010	Relatively fast; 290 days in 2010
Contract Enforcement Cost	Relatively low cost; 18.3% of debt in 2010	Relatively low cost; 22.0% of debt in 2010	Relatively high cost; 32.5% of debt in 2010	High cost; 37.7% of debt in 2010	Relatively low cost; 24.3% of debt in 2010	Relatively low cost; 25.5% of debt in 2010
Public Credit Registry Coverage	High coverage; 16.8% of adults in 2010	Moderate coverage; 10.9% of adults in 2010	High coverage; 16.1% of adults in 2010	High coverage; 15.8% of adults in 2010	Low coverage; 5.6% of adults in 2010	Moderately low coverage; 9.6% of adults in 2010

Private Credit Bureau Coverage	Reasonably high coverage; 33.8% of adults in 2010	High coverage; 38.9% of adults in 2010	Reasonably high coverage; 30.5% of adults in 2010	Moderate coverage; 24.5% of adults in 2010	Low coverage; 12.2% of adults in 2010	Low coverage; 10.8% of adults in 2010

4. Financial Sector and Macroeconomic Stability



General financial sector stability trends show the vulnerability of many economies to the recent economic turmoil. While some countries have been less affected due to their limited links with and exposures to the international capital markets, most have shown challenges regarding capital adequacy (e.g., excessively high levels to counter potential risks of default), rising non-performing loans, the need to increase provisions for non-performing loans, and a consequent decline in earnings as manifested in weak return measures. Other challenges include credit and deposit growth/contraction patterns. These are all intertwined with macroeconomic developments, particularly as this concerns (1) lending patterns in support of consumer purchases, and the impact this has had on current account balances, (2) competitiveness in export sectors, the impact this has had on reserves and exchange rates, and the consequent impact this has had on inflation rates, interest rates, and public confidence in local currency, and (3) how macroeconomic shocks, including disruptions in trade and investment, have culminated in declining loan quality and returns and, more recently, the availability of credit.

Financial sector stability trends show the vulnerability of many economies to the recent economic turmoil. While some countries have been less affected due to their lack of connection with the international capital markets, most have shown challenges regarding capital adequacy (e.g., excessively high levels to counter potential risks of default), rising non-performing loans, the need to increase provisions for non-performing loans, and a consequent decline in earnings. Other challenges include credit and deposit growth/contraction patterns... These are all intertwined with macroeconomic developments, particularly as this concerns (1) lending patterns in support of consumer purchases, and the impact this has had on current account balances, (2) competitiveness in export sectors, the impact this has had on reserves and exchange rates, and the consequent impact this has had on inflation rates, interest rates, and public confidence in local currency, and (3) how macroeconomic shocks, including disruptions in trade and investment, have culminated in declining loan quality and returns and, more recently, the availability of credit.

In general, perceptions of banking sector soundness show higher levels of confidence in the underlying stability of CEE NORTHERN TIER, albeit at levels below the Eurozone, followed by CEE SOUTHERN TIER and then EURASIA. This is indicated in a graphic from the World Economic Forum from 2007-10.

- *Capital Adequacy Ratios*: CARs correlate broadly with perceived levels of economic and financial sector development--the highest CARs are generally in the markets with the greatest perceived risk of loss-given default, such as in EURASIA. However, Turkey and Croatia also have high CARs, which also shows that some markets are also tightly regulated to compensate for potential market risks. At the other end of the spectrum, low or negative CARs reflect undercapitalization, also a sign of weakness and potential instability. Among the regions under review, all three have shown steady increases in CARs since 2007 in the face of continued economic instability and loan losses. Higher CARs help to protect against losses, but also reflect perceptions of risk in markets as well as the limitations on asset allocation choices available to lenders to mitigate risks.

- *Non-performing Loans*: NPLs represent a growing problem throughout the entire region as they are increasing in most countries. Only six of the 25 countries which had data on these figures had NPLs of 4 percent or less on average from 2007-10, while 10 had NPLs exceeding 8 percent on average.

- *Provisions for Loan Losses*: There are wide variations in provisioning patterns, with many countries aggressively provisioning for loan losses, while others have eased up in the last couple of years as NPLs have mounted. Specific countries that may need to increase their provisioning for loan losses include **Albania, Montenegro** and Romania, where provisioning has been low and NPLs have risen to 12 percent or higher as of 2010.

- *Return on Assets*: RoA patterns differ from other Financial Sector Stability patterns in that the more "advanced" economies of CEE NORTHERN TIER had the lowest RoA, and EURASIA had the highest. RoA was strong (above 2 percent) in only three countries--**Armenia, Moldova** and Turkey. Conversely, RoA was particularly weak in the Baltic states, **Ukraine, Montenegro** and **Georgia**, all of which showed negative returns on average for the 2007-10 period.

- *Credit Growth*: All three regions have shown a decline in credit growth year on year, with CEE NORTHERN TIER showing a contraction of nearly 1 percent in 2009 while the other regions registered declines and, in some countries, contractions. Twelve of 27 countries for which data are available showed credit contraction (negative growth) in 2009. The pattern reflects a natural adjustment in light of rising NPLs, the need for higher capital adequacy, and from a macroeconomic perspective, the need to reduce current account deficits that were symptomatic of overheated economies or excessive consumption at the expense of savings and investment.

- *Private Sector Credit*: Two general patterns occurred in 2007-09. The first pattern showed each region having a set of countries that sustained increased private sector lending for all three years, but with declines year on year. A second group in each region showed lending declines in 2009, and a relative shift in resources away from the private sector into investments in government securities. In those countries that showed declines in lending in 2009 (**Armenia, Bosnia**, Estonia, **Georgia**, Hungary, Kyrgyz Republic, Latvia, Lithuania, **Moldova, Montenegro, Ukraine**), most showed growth rates exceeding 70 percent in 2007, and many showed a significant increase in NPLs as well.

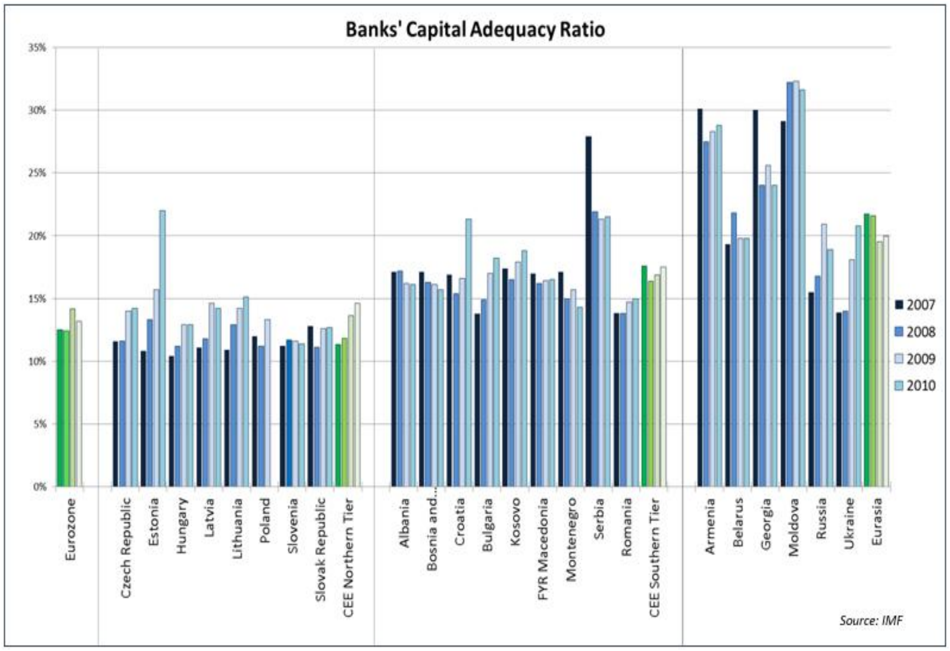
- *Foreign Exchange Loans*: Data on the foreign exchange (FX) portion of total loan portfolios indicates the degree of market risk and investor confidence in the system, which can have a major impact on monetary policy, exchange rates, balance of payments, and sovereign debt ratings. The figures show high exposure in CEE SOUTHERN TIER countries (43.2 percent), moderate exposure in EURASIA (30.7 percent), and low exposure in the CEE NORTHERN TIER countries (21.8 percent). These ratios have risen slightly in CEE SOUTHERN TIER but declined in EURASIA. PFS Beneficiary countries have about one third of their portfolios FX-denominated.

- *Deposits*: Most countries showed deposit growth in all three years (2007-09), although some experienced net deposit outflows in 2008 and/or 2009. This was particularly true for **Montenegro** and **Ukraine**, where deposit contraction was 8-9 percent. In all three regions, deposit growth rates in 2009 were a small fraction of what they were in 2007.

- *Foreign Exchange Deposits*: Data on the foreign exchange (FX) portion of deposits indicates the degree of public confidence in the local currency and domestic banking system, potential volatility of capital flows, and exchange rate policy, all of which directly impact and reflect competitiveness. The figures show high FX deposits in CEE SOUTHERN TIER countries (52.6 percent) and EURASIA (53.4 percent), with comparatively low levels in the CEE NORTHERN TIER countries (25.9 percent). PFS Beneficiary countries have higher levels in their respective regions than the norm, raising questions about public confidence in these countries.

- *Loan-to-Deposit Coverage*: Loan-to-deposit ratios serve as a basic proxy for potential liquidity or funding mismatches that can trigger serious refinancing and portfolio restructuring problems. These ratios show high levels of lending in the 2007-09 period relative to deposits in CEE NORTHERN TIER and EURASIA, with only a modest slowdown in 2009 after increases continued through 2008. By contrast, CEE SOUTHERN TIER countries maintained reasonably modest levels of lending throughout the period, and did not exhibit the same tendency toward leverage that occurred in the other two regions. CEE NORTHERN TIER and EURASIA regions averaged nearly 160 percent loan-to-deposit ratios in 2007-09, meaning simplistically that 60 percent (or more) of loans were financed by other liabilities. Thus, in a negative scenario, any problem that banks in these regions faced in refinancing the 60 percent would come back to potentially create a liquidity crisis for the bank. By contrast, CEE SOUTHERN TIER averaged nearly 111 percent, which is reasonably close to full matching of deposits and loans.

4.1. Capital Adequacy Ratios (CARs)



Capital adequacy ratios (CARs) in the region show that lower CARs are found in the more "advanced" economies of CEE NORTHERN TIER, as measured by entry into the EU, higher per capita incomes, etc., while the higher CARs are generally found in EURASIA, the region with the highest perceived risks. However, Croatia and Turkey, two countries that are considered more advanced than CEE SOUTHERN TIER and EURASIA, have higher average CARs than the CEE SOUTHERN TIER. Thus, this logic should not be interpreted as correlating economic development with low CARs *per se*. Rather, CARs in 11-15 percent range are considered prudent in the more advanced OECD economies. Korea's CAR averaged 13.4 percent during this period, while advanced economies as a whole showed an average of 13.3 percent for this period and increases in 2009-10 in response to the global financial crisis. (By contrast, the Eurozone showed a decline in CARs in 2010, although its 2007-10 average was consistent with the norm for the advanced economies.)

Risk-adjusted capital requirements increase based on perceived risk, with very high ratios reflecting the defensive posture of the banks in markets where loss-given default risk (including unexpected losses) is high. As such, many banks in the higher-risk markets invest in government securities with low or zero risk weights instead of lending to the real sector, increasing their CARs. This can be done in any market, and is an effective method of recapitalizing or simply maintaining a relatively safe portfolio in a high-risk environment. However, in the end, more advanced economies show more risk-taking, and lower CARs there often reflect broadly diversified portfolios where default risk is lower and the legal/regulatory framework provides banks with opportunities to more easily recover on losses through contract enforcement measures (e.g., workouts, foreclosures, liquidations).

At the other end of the spectrum, high-risk markets can also have low or even negative CARs when serious problems emerge. However, apart from Kazakhstan (among the countries for which data are available), this has not been the case among the subject countries.

In general, the following trends and observations are made regarding capital adequacy ratios:

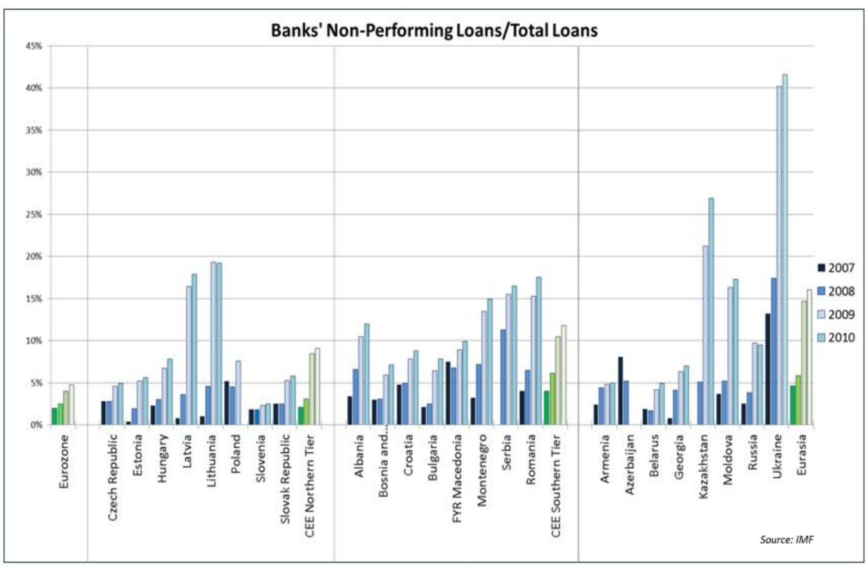
- CEE NORTHERN TIER: The average CARs for this region were the lowest among the countries reviewed, at 12.9 percent from 2007-10, although they have shown steady increases during the period and were at 14.6 percent in 2010. The 12.9 percent figure is roughly in line with advanced economies. Estonia and Lithuania have maintained CARs above the regional average, whereas the other countries (Czech Republic, Hungary, Latvia, Poland, Slovakia, Slovenia) have maintained CARs at or below the average for this cohort.

- *CEE SOUTHERN TIER*: This region has shown fluctuation, with an average 17.1 percent for 2007-10, but falling in 2008 before rebounding in 2009 and rising to 17.5 percent in 2010. This clearly represents a higher level of capital adequacy than CEE NORTHERN TIER , and slightly below the EBRD-29 average of 18.6 percent for 2007-10. However, the data for CEE SOUTHERN TIER are largely skewed by **Serbia**, which had a very high 27.9 percent CAR in 2007, dropping to the 21-22 percent range in 2008-10. **Albania, Bosnia**, Bulgaria, **Macedonia, Montenegro** and Romania were all below the 17.0 percent average, while **Kosovo** was slightly higher at 17.7 percent.

- *EURASIA*: Average CARs for this region were 20.7 percent, and a high at 24.6 percent for the PFS Eurasian countries, nearly double the average for CEE NORTHERN TIER and significantly higher than the EBRD average. (The data exclude **Azerbaijan**.) **Armenia, Georgia and Moldova** had particularly high CARs, while **Belarus** (20.2 percent), Russia (18.0 percent) and **Ukraine** (16.7 percent) had CARs closer to the CEE SOUTHERN TIER norm. Data for Central Asia are only available for Kazakhstan, where CARs were a low 4.2 percent during the 2007-10 period, the lowest of all countries under review. Loan losses have depleted capital in Kazakhstan, where CARs were negative in 2009-10 after being reasonably high in 2007-08 (14-15 percent).

4.2. Non-Performing Loans (NPLs)

NPL patterns are somewhat consistent with CAR patterns. The more advanced economies of CEE NORTHERN TIER had lower NPLs on average than the other regions, while EURASIA had the highest levels. (There was little difference between PFS and non-PFS EURASIA Beneficiary countries.) However, CEE NORTHERN TIER shows the regional average is skewed by Latvia and Lithuania, and EURASIA is particularly skewed by **Ukraine**. The seven CEE NORTHERN TIER and four EURASIA countries with reasonably low NPLs are more similar in that regard, while the two CEE NORTHERN TIER markets with high NPLs more closely resemble some of the CEE SOUTHERN TIER countries with the highest NPLs.



Meanwhile, the steady rise in CARs in CEE NORTHERN TIER occurred simultaneously as NPLs increased, which they have in all the regions. However, in CEE SOUTHERN TIER and EURASIA, NPLs increased while CARs showed little change between 2007 and 2010. Looking at the countries where NPLs increased the most, CARs moved up in **Ukraine**, Latvia and Lithuania. Thus, while countries with problem loans have increased regulatory capital, it is not clear if the CAR increases are sufficient relative to the NPL challenge.

Meanwhile, Croatia and Turkey showed NPLs to be far lower than all three regions, at 1.1 percent and 4.5 percent, respectively. This compares with 1.1 percent in Korea for 2007-10, and 2.2 percent more broadly among advanced economies[20]. The Eurozone average for 2007-10 was 3.3 percent, reflecting more severe asset quality problems in that cohort compared with the broader grouping of advanced economies. As elsewhere, NPLs have increased in the advanced economies since 2008.

In general, the following trends and observations are made regarding non-performing loans:

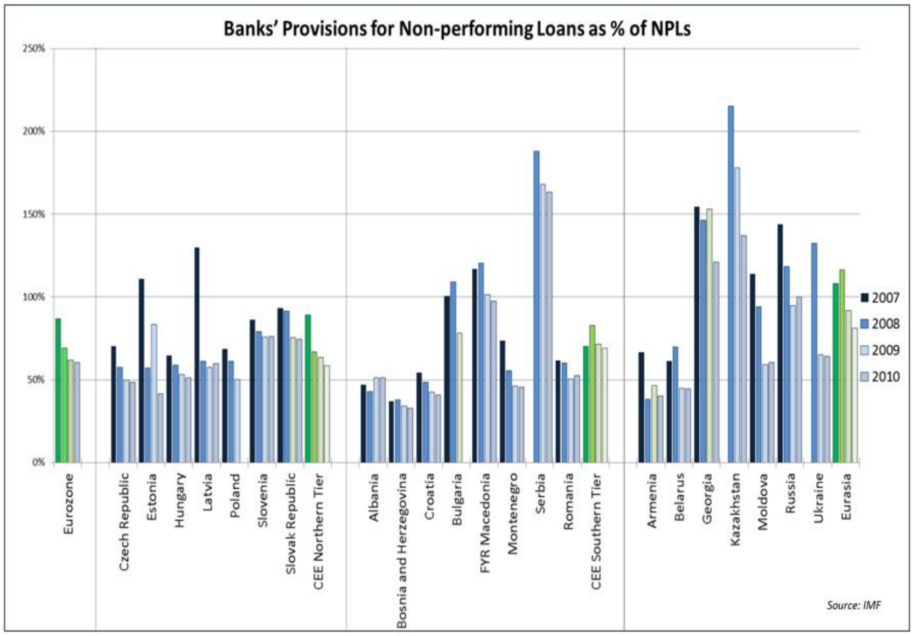
- *CEE NORTHERN TIER*: The average NPLs for this region were the lowest among the countries reviewed, at 5.7 percent, from 2007-10. While lower than the other regions, they showed a steady increase, from a low 2.1 percent in 2007 to 9.0 percent in 2010. Czech Republic, Estonia, Hungary, Poland, Slovakia and Slovenia have kept NPLs at about or below the average, whereas NPLs have been very high in Latvia and Lithuania, at about 10 percent. Among the last two countries, the challenge has been particularly deep, with NPLs in the 15-20 percent range in 2009-10, higher than the average for EURASIA during these two years.

- *CEE SOUTHERN TIER*: As with the other regions, CEE SOUTHERN TIER has experienced a steady increase in NPLs, from 3.4 percent in 2007 to 10.9 percent in 2010. The average for the period was 7.4 percent, which is lower than the EBRD average of 8.6 percent**. Albania, Macedonia, Montenegro**, Romania and **Serbia** all showed above average levels of NPLs, particularly **Serbia** (which also has the highest CARs) and Romania, while Bulgaria's and **Bosnia's** NPLs are the lowest for the region at about 4.8 percent. (Data were not available for **Kosovo**.)

- *EURASIA*: Average NPLs for this region were 10.3 percent, and were more than three times the level in 2010 (16.0 percent) than they were in 2007 (4.7 percent). (The data exclude **Azerbaijan** for 2009-10, although its average in 2007-08 was slightly higher than the regional average those two years.) The PFS EURASIA Beneficiary countries showed a similar pattern, with NPLs in 2010 three times the level they were in 2007. However, the data are entirely skewed by **Ukraine**, which showed high levels in 2007-08 (average 15.3 percent for those two years) skyrocketing to more than 40 percent from 2009 on. **Armenia, Belarus, Georgia** and Russia all have NPLs in the 3.2-6.4 percent range, which means their performance is more comparable to the better performing countries in the other two regions. **Moldova's** average of 10.6 percent is below the regional average, although its problems have worsened significantly since 2009. Data for Central Asia are only available for Kazakhstan, where NPLs have increased to levels exceeding 21 percent in 2009-10. Apart from **Ukraine**, Kazakhstan's average is the highest among all countries under review.

[20] Iceland is excluded as an outlier.

4.3. Provisions for Loan Losses



There are several distinct patterns regarding provisions for loan losses. The *CEE NORTHERN TIER* region shows coverage averaging about 70 percent for 2007-10, very similar to CEE SOUTHERN TIER (73.5 percent average) and virtually identical to the Eurozone average. These are below EURASIA and PFS SOUTHERN TIER. Surprisingly, the higher provisions are positively correlated with higher earnings, as RoA has actually been higher in PFS EURASIA and then CEE SOUTHERN TIER when compared with CEE NORTHERN TIER. However, this pattern breaks down completely when evaluating Kazakhstan, which has had high provisions and negative returns. More importantly, countries with high NPLs (e.g., about 10 percent or higher) generally show high levels of provisions (e.g., above 80 percent of NPLs). This is true in Kazakhstan, **Moldova, Serbia and Ukraine**. Where there is a gap, such as in **Montenegro** and Romania, this may point to a potentially significant drop in earnings if provisioning deficiencies are corrected and NPLs increase. **Albania** may also need to increase provisions as NPLs have exceeded 10 percent since 2009, and provisions were only 51 percent. (Data are not available for Lithuania, where NPLs averaged 11 percent in 2007-10 and were above 19 percent in 2009-10.)

By contrast, Turkey has good provisioning coverage at 83.4 percent of its 4.5 percent NPLs. Croatia's provisions have steadily declined since 2006 (and possibly before), but its NPLs are only 1.1 percent.

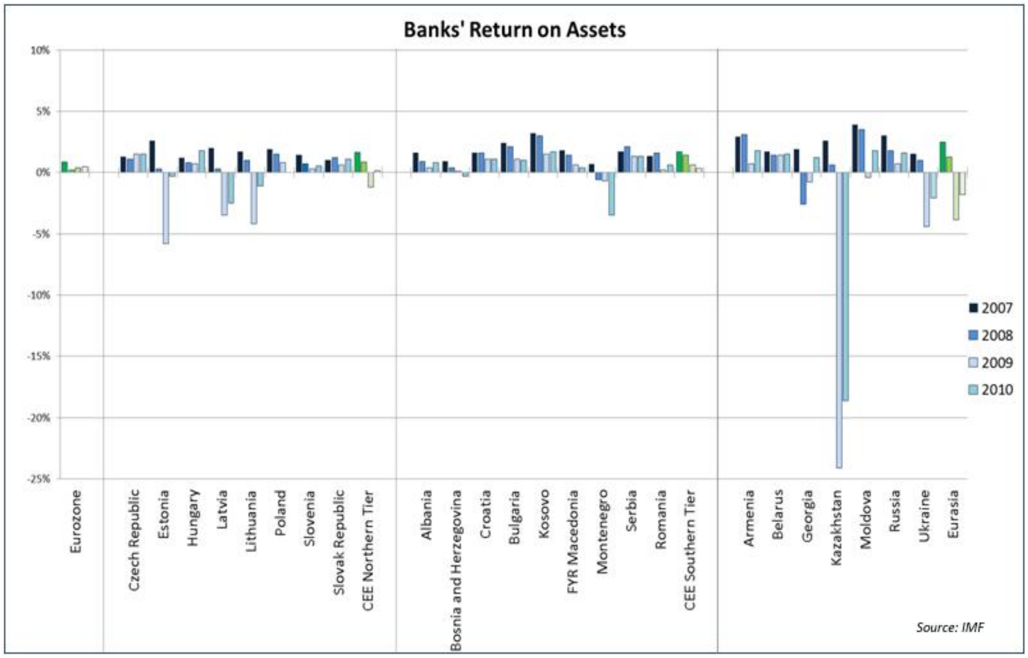
In the more advanced economies, Korea shows very strong coverage of 155 percent from 2007-10, although this has declined year on year since 2008. In general, the advanced economies show bank provisions to be about 71.5 percent of NPLs, with the Eurozone just slightly below this average.

In general, the following trends and observations are made regarding bank provisioning for non-performing loans:

- *CEE NORTHERN TIER*: The average provisions for NPLs for this region were the lowest among the countries reviewed, at 69.5 percent from 2007-10. Several countries show low levels of provisioning (about 60 percent or below) in recent years, including Estonia (2008 and 2010), Hungary (since 2008), Latvia (since 2008), and possibly Lithuania (no provisioning data, but high NPLs). Slovakia and Slovenia have been more aggressive with their provisioning (at 80 percent or more), while the Czech Republic and Poland have been less aggressive, but also do not have serious problems with NPLs.

- *CEE SOUTHERN TIER*: As CEE SOUTHERN TIER has experienced a steady increase in NPLs, its banks have also been aggressive provisioning for these losses. The region as a whole shows an average 84.3 percent provisioning for NPLs. However, this is largely skewed by **Serbia** and **Macedonia**. **Albania, Bosnia,**

Montenegro and Romania all show relatively low levels of provisioning, particularly **Bosnia** (less than 36 percent). Potentially more serious in terms of gross under-provisioning is the gap between NPLs and provisions in Romania, **Montenegro** and **Albania**, where NPLs were 12-18 percent in 2010, and provisioning was only 46 percent in **Montenegro,** 51 percent in **Albania**, and 53 percent in Romania. Bulgaria has been aggressive, with high provisioning ratios in 2007-09. (No data were available for **Kosovo**.)



- *EURASIA*: NPLs have increased significantly in this region since 2009, yet banks are provisioning aggressively at 99.3 percent of NPLs from 2007-10 for the region as a whole, and 83.8 percent among PFS EURASIA Beneficiary countries. **Georgia** and Russia have been particularly aggressive, at 144 percent and 114 percent, respectively. **Ukraine and Moldova** have also been reasonably aggressive, provisioning for more than 80 percent of NPLs since 2007. However, **Ukraine's** provisioning has eased since 2009 during a period when its NPLs have exploded to more than 40 percent. Likewise, **Moldova** has shown the same pattern of easing while its NPLs have increased to about 17 percent. Meanwhile, **Armenia and Belarus** have been far less aggressive in recent years with provisioning, but these two countries also report the lowest NPLs in the region at about 3-4 percent for 2007-10, and about 5 percent in 2010. (No data were available for **Azerbaijan**.) Data for Central Asia are only available for Kazakhstan, where provisioning for NPLs has been very aggressive at 177 percent since 2008, while NPLs have increased from 5.1 percent in 2008 to nearly 27 percent in 2010.

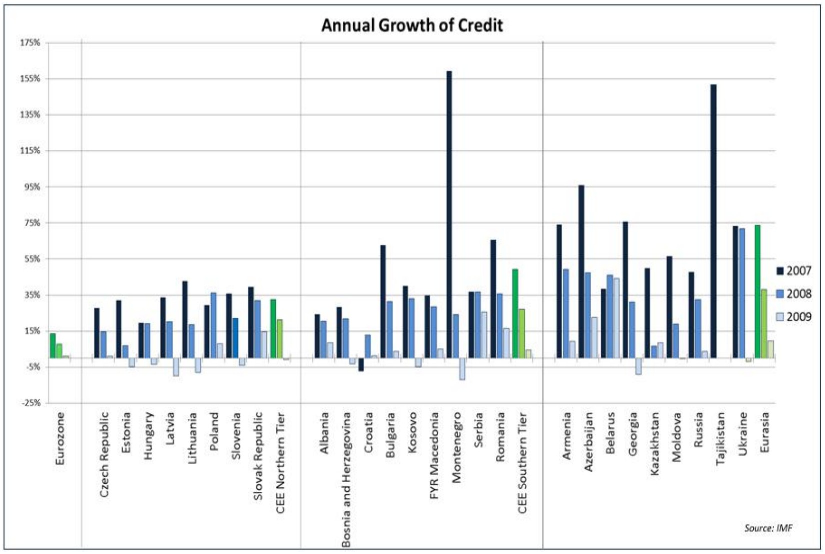
4.4. Return on Assets (RoA)

Return on assets (RoA) has been weak in all regions during the 2007-10 period, particularly the Baltic states. On average, RoA has been highest in CEE SOUTHERN TIER, although the trend there has been steady decline since 2008. CEE NORTHERN TIER has shown weakness since 2008, with a net negative in 2009 and very feeble returns in 2010. In this tier, the Central European markets have fared reasonably well, but the regional averages have been skewed by the losses experienced in the Baltics since 2009. In general, the 12 PFS Beneficiary countries have had higher RoA than the other groupings, including the Eurozone and advanced economies, although lower than Turkey and Croatia.

Turkey's comparatively high 2.4 percent RoA, and Croatia's respectable 1.4 percent are both well above other groupings. In Korea, RoA averaged 0.7 percent for the 2007-10 period. This compares with a ratio of 0.55 percent for advanced economies, and 0.48 percent for the Eurozone.

In general, the following trends and observations are made regarding return on assets:

- *CEE NORTHERN TIER*: The average RoA for this region was less than 0.4 percent from 2007-10. RoA has been less than 1 percent since 2008, was a negative 1.2 percent in 2009, and barely above zero (0.14 percent) in 2010. These results are largely skewed by the Baltics, as all three countries had deep losses in 2009 approximating a negative 4.5 percent for the year. Thus, all three of these countries have had negative RoA for the period due to losses in 2009-10. By contrast, the non-Baltic markets have shown reasonable average returns for the 2007-10 period. Czech Republic, Hungary, Poland, Slovakia and Slovenia have all been at about or above 1 percent RoA for the period.



- *CEE SOUTHERN TIER*: The region's RoA averaged 1.0 percent for the 2007-10 period, although the trend has been steadily negative year on year since 2008. **Albania, Kosovo, Macedonia and Serbia** have shown above average ratios, with **Kosovo's** performance the strongest of the region at 2.4 percent. **Serbia's** returns have also been strong at 1.6 percent despite rising NPLs and high CARs. **Bosnia** has shown weak but positive earnings at about 0.5 percent RoA, while **Montenegro** has experienced losses since 2008 and skewed the average downward for the region. Thus, much of CEE SOUTHERN TIER has performed well apart from **Montenegro**.

- *EURASIA*: RoA for this region was negative due to Kazakhstan, but the PFS EURASIA Beneficiary countries averaged 0.95 percent for 2007-10, despite losses in 2009. While PFS EURASIA showed higher RoA on average than the other two regions, the trend has been volatile. RoA declined nearly half in 2008, showed losses in 2009, and then re-emerged in 2010 at about one-third 2007 earnings. However, the results are skewed by **Ukraine's** poor performance in 2009-10, where the increase in NPLs has triggered losses, resulting in **Ukraine** (along with **Montenegro**) having the lowest average of all countries under review. **Georgia** has been slightly negative at negative 0.1 percent due to losses in 2008-09. Apart from **Ukraine** and **Georgia**, the other EURASIA markets apart from Kazakhstan have shown reasonable RoA. **Armenia, Belarus, Moldova** and Russia have all shown fairly high returns, particularly **Armenia** and **Moldova**, two of the three countries (with Turkey) whose RoA exceeded 2 percent for the period. (No data reported for **Azerbaijan**.) Meanwhile, data for Central Asia are only available for Kazakhstan, which showed significant losses in 2009-10 that have brought down the ratio to nearly negative 10 percent for the full four-year period from 2007-10. This is correlated with the major run-up in NPLs and decline in CARs in 2009-10.

4.5. Credit Growth

All regions have shown a general decline in rates of credit growth after 2007, with at least 12 countries showing credit contraction in 2009. On average, EURASIA and CEE SOUTHERN TIER have shown continued increases, albeit declining each year from 2007-09. In CEE NORTHERN TIER, growth declined in 2008 and then contracted by nearly 1 percent in 2009.

Turkey showed steady credit growth averaging 20.7 percent for the 2007-09 period, while Croatia averaged only 2.2 percent, although this was brought down by the 7.2 percent contraction in 2007. Thus, both Turkey and Croatia have shown growth during the 2008-09 period when many markets had to adjust to global instability.

By comparison, the Eurozone countries registered only 7.4 percent growth on average for 2007-09, well below the CEE/EURASIA regions.

In general, the following trends and observations are made regarding credit growth:

- *CEE NORTHERN TIER*: Credit growth averaged 17.7 percent from 2007-09 in the region. However, the region has been characterized by considerable volatility in credit growth rates. In 2007, credit growth was 32.6 percent, compared with negative 0.8 percent in 2009. Lithuania, Poland and Slovakia showed strong credit growth, although all three showed lower levels in 2009 than in earlier years. The Czech Republic, Estonia, Hungary, Latvia and Slovenia were all roughly at or below the regional average.

- *CEE SOUTHERN TIER*: The region's credit growth averaged 27 percent for the 2007-09 period, significantly higher than CEE NORTHERN TIER, albeit following the same trend as the other regions with year-on-year declines in virtually all markets. In 2007, credit growth was 49.4 percent, compared with 4.5 percent in 2009. Growth on average was strongest in **Montenegro**, at 57.1 percent, although this is distorted by 2007 growth of nearly 160 percent. Moreover, as noted above, **Montenegro** also faces significant difficulties with non-performing loans that have triggered provisions and reduced earnings. Romania and Bulgaria also showed strong growth, averaging 33-39 percent. **Serbia** has shown considerable credit growth averaging 33 percent, although it also faces problems with its non-performing loans. **Macedonia** and **Kosovo** showed credit growth of 22.7 percent for the period, with asset quality problems (in **Macedonia**) that are less severe than in **Montenegro** and **Serbia**. **Albania** and **Bosnia** showed credit growth below the regional average, with credit contracting in **Bosnia** by 3.1 percent in 2009.

- *EURASIA*: Credit growth was strongest in EURASIA at 41 percent for 2007-09. However, **Ukraine** has distorted the regional analysis with its run-up of non-performing loans. The result is that **Ukraine** averaged 47.8 percent credit growth from 2007-09, but contracted by 2 percent in 2009. Apart from **Ukraine**, the region showed robust growth. **Azerbaijan**, in particular, showed high levels of credit growth (55.3 percent) powered by the oil sector, while **Armenia, Belarus, Georgia, Moldova** and Russia all showed growth as well, ranging from 25-28 percent in **Moldova** and Russia to 43-44 percent in **Armenia** and **Belarus**. In general, the region showed a decline or contraction in 2009, apart from **Belarus**, which has shown steady and consistent credit growth during the crisis. Data for Central Asia are incomplete. However, Kazakhstan has shown positive growth year on year, while Mongolia showed contraction in 2009.

4.6. Private Sector Credit Growth

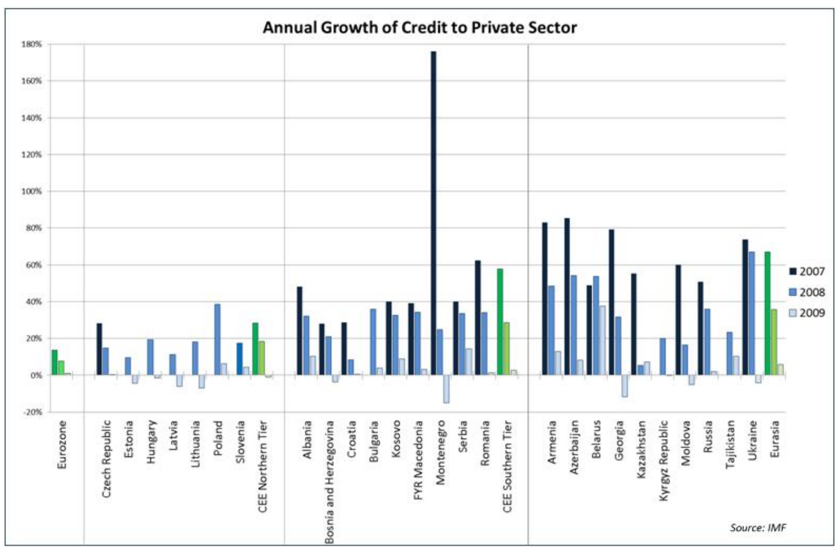
As with general trends in credit, all regions have shown a general decline in rates of credit growth to the private sector after 2007, with at least 10 countries and one region showing contraction in 2009. On average, private sector credit growth or contraction was virtually identical with overall credit trends in CEE NORTHERN TIER, whereas EURASIA and CEE SOUTHERN TIER showed some growth in investments in government securities which may have been at the expense of private sector lending. This would be a logical risk-averse response to deteriorating market conditions and/or pressure by bank regulators on banks to strengthen CARs.

Meanwhile, Turkey showed reasonable albeit declining growth in credit to the private sector, with about half of growth in overall credit in 2009 being investments in government securities. In Croatia, credit to the private sector was positive, particularly in 2007, but dropped off significantly in 2008-09.

In the Eurozone, private sector credit growth was less than 7.4 percent[21] for 2007-09, and less than 1 percent in 2009.

In general, the following trends and observations are made regarding private sector credit growth:

- *CEE NORTHERN TIER*: Private sector credit growth averaged 15.2 percent from 2007-09 in the region. As with general credit growth trends, there has been volatility. In 2007, private sector credit grew 28.3 percent, as compared with negative 1.2 percent in 2009. Poland showed growth at or in excess of 22 percent, although private sector credit growth was in single digits in 2009. Other countries in the region showed lower levels of growth, with several contracting in 2009 (Estonia, Hungary, Latvia, Lithuania).

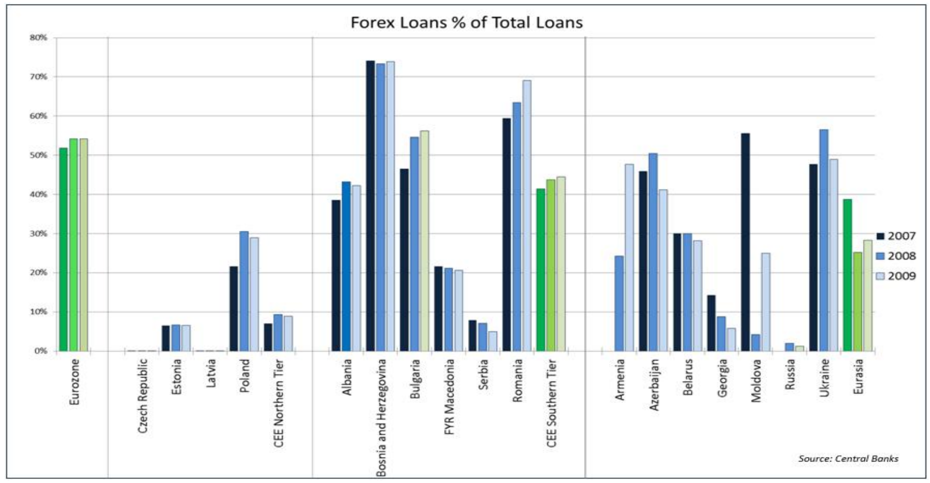


- *CEE SOUTHERN TIER*: The region's private sector credit growth averaged nearly 30 percent for the 2007-09 period, higher than CEE NORTHERN TIER, albeit following the same trend as the other regions with year-on-year declines in virtually all markets. Growth was strongest in **Montenegro**, at 71.4 percent, although this is distorted by 2007 growth of 208.5 percent. As noted above, **Montenegro** also faces significant difficulties with non-performing loans that have triggered provisions and reduced earnings, and its private sector lending contracted in 2009 after slowing considerably in 2008. Romania and **Albania** showed average private sector credit growth of about 31-32 percent for the period, although growth rates declined precipitously in Romania in 2009 while, in **Albania**, banks increased their investments in government securities. **Serbia** has shown strong private sector credit

[21] It is not possible to specify lending to private sector enterprises vs. state-owned enterprises from existing statistics. The Euro Area only reports "Claims on Other Sectors" after reporting claims on government. However, there are many enterprises that are partly or wholly state-owned that are run commercially and not considered Government except in terms of ownership.

growth (29.3 percent), although it also faces problems with its non-performing loans. **Kosovo** showed strong growth of 27.2 percent for the period. **Macedonia** also showed strong private sector credit growth of 25.5 percent for the period, with asset quality problems that are less severe than in **Montenegro and Serbia**. **Bosnia** and Bulgaria showed credit growth below the regional average, with private sector credit contracting in 2009 after achieving fairly high levels in 2007-08.

- *EURASIA*: Private sector credit growth was strongest in EURASIA in 2007-08, above all in the PFS EURASIA Beneficiary countries. However, as elsewhere, private sector credit growth slowed to 6 percent growth in 2009. **Armenia, Azerbaijan, Georgia, Moldova and Ukraine** all showed at least 23 percent average growth in private sector lending in 2007-09, with **Azerbaijan and Armenia** at 48-49 percent, yet all five showed major declines in growth or actual contraction (negative growth) in 2009. Thus, all five countries have shown volatility in lending patterns, and a more general shift in 2009 towards investment in government securities instead of lending to the private sector. Meanwhile, **Azerbaijan, Belarus** and Russia all showed positive growth in private sector credit patterns similar to the stronger CEE NORTHERN TIER performers, with declines year on year, yet positive growth in all three years at 30 percent or more on average. Data for Central Asia show patterns similar to CEE SOUTHERN TIER, with positive but declining year-on-year lending to the private sector. Kazakhstan has faced serious challenges to capital adequacy in 2009-10, and this has triggered slower growth in private sector lending in 2008-09. The Kyrgyz Republic showed contraction in 2009 after 20 percent growth in 2008. Mongolia and Tajikistan have shown positive but declining private sector lending throughout the 2007-09 period.



4.7. Foreign Exchange Loans/Total Loans

Data on the foreign exchange (FX) portion of total loan portfolios indicate the degree of market risk and investor confidence in the system, which can have a major impact on monetary policy, exchange rates, balance of payments, and sovereign debt ratings. The figures show particular exposure in CEE SOUTHERN TIER countries (43.2 percent), moderate exposures in EURASIA (30.7 percent), and low exposures in the CEE NORTHERN TIER countries (21.8 percent). These ratios have risen slightly in CEE SOUTHERN TIER but declined in EURASIA. PFS Beneficiary countries have about one third of their portfolios FX-denominated.

In the Eurozone, the foreign exchange component of loans was a high 53.4 percent from 2007-09. Most of this is presumed to be in US dollars, UK sterling, Swiss franc and yen.

In general, the following trends and observations are made regarding FX credit:

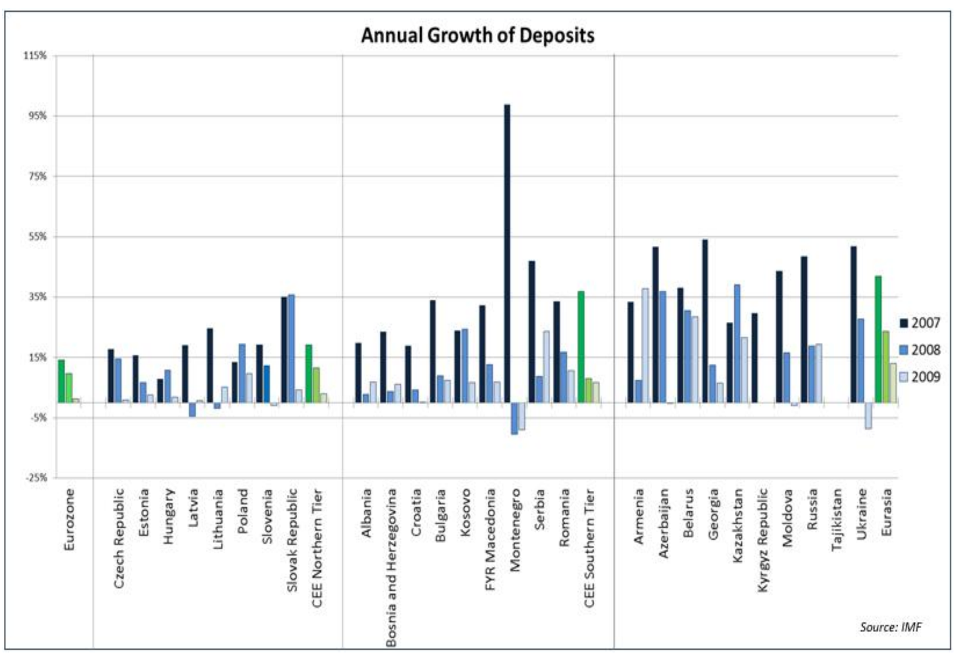
- *CEE NORTHERN TIER*: FX credit is small as a share of total loans in this region, averaging 21.8 percent in 2007-09 and showing little change or volatility. Apart from the Czech Republic, countries reporting data showed limited foreign exchange exposure on loans[22].

- *CEE SOUTHERN TIER*: The region's FX loans to total were the highest of the regions under review. The average for 2007-09 was 43.2 percent, peaking at 44.5 percent in 2009. The PFS Beneficiary countries of the region were lower than this, at about 35 percent of total. **Bosnia** (73.8 percent) had the highest figures, whereas **Serbia** (6.7 percent) had the lowest. **Albania** (41.3 percent) and **Macedonia** (21.2 percent) were in between. Bulgaria (52.5 percent) and Romania (64 percent) were at the high end of the scale for the region. (No data for **Kosovo** or **Montenegro**).

- *EURASIA*: The region's FX loans were reasonably low at 30.7 percent on average from 2007-09. PFS Beneficiary countries were a bit higher at 33.5 percent. **Ukraine** had the highest average among PFS Beneficiary countries, at 51.1 percent. **Armenia** (36 percent) showed significant volatility, doubling from 2008 to 2009. **Azerbaijan** has operated within a 40-50 percent range during those three years. **Georgia** has the lowest FX loan figures for PFS Beneficiary countries of the region, at less than 10 percent for the 2007-09 period. **Belarus** has been fairly consistent at about 29.4 percent. **Moldova** had an average of 28.3 percent for the period, similar to **Belarus**, but with significant year-on-year volatility. Russia showed low FX loans as a share of total at 1.6 percent.

4.8. Deposit Growth

Deposits have grown in all regions, with EURASIA showing the highest (26 percent) increase in deposit growth rates throughout the period, followed by CEE SOUTHERN TIER (17 percent) and CEE NORTHERN TIER (11 percent). Only **Azerbaijan, Moldova Montenegro**, Slovenia and **Ukraine** showed declines in deposits in 2009, with declines in **Montenegro and Ukraine** being particularly severe in the 8-9 percent range. Most PFS Beneficiary countries increased levels of deposit insurance coverage, helping to preserve public confidence in the system.



Turkey showed very strong deposit growth of 18 percent from 2007-09. Croatia showed growth of nearly 8 percent, although nearly zero percent in 2009.

During this period, the Eurozone showed 8.4 percent growth on average, with a steady year-on-year decline reflecting the impact of the financial crisis on the

[22] The data may be partly distorted due to the limited number of countries for which foreign exchange loan data are available.

economy. Deposit growth was a low 1.3 percent in 2009.

In general, the following trends and observations are made regarding deposit growth:

- *CEE NORTHERN TIER*: Deposit growth averaged 11.2 percent from 2007-09 in the region. This was uneven, with 19.1 percent growth in 2007, but only 3 percent growth in 2009. Slovakia and Poland showed particularly strong growth, while the Czech Republic and Slovenia were consistent with the regional average. By contrast, Estonia, Hungary, Latvia and Lithuania showed lower than average levels of growth.

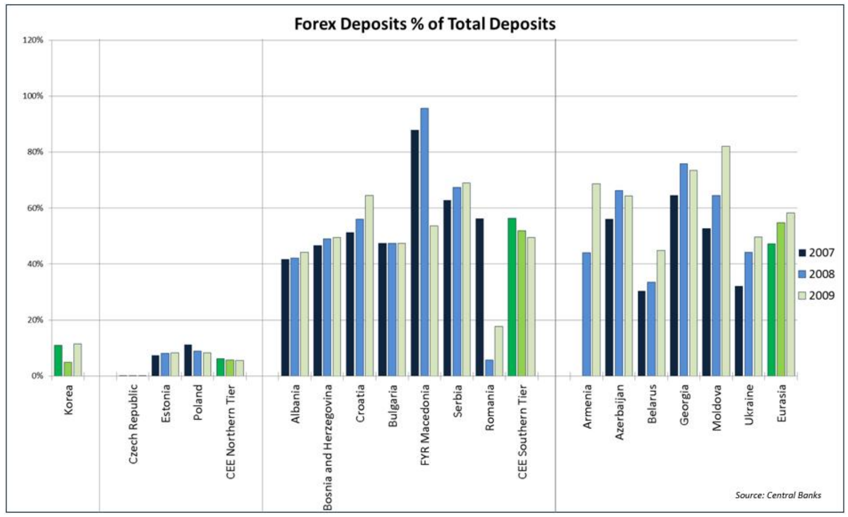
- *CEE SOUTHERN TIER*: The region's deposit growth averaged 17.1 percent for the 2007-09 period, with the PFS SEE Beneficiary countries slightly higher at 18.2 percent. As with the other regions, CEE SOUTHERN TIER has shown year-on-year declines in deposit growth rates. Growth has been strongest in **Serbia and Montenegro**, at 26.4 percent, although **Montenegro's** figures are distorted by 2007 growth of 99 percent. By contrast, **Serbia** has shown growth in all three years, with strong growth exceeding 23 percent in 2009. Romania's 20 percent growth was slightly higher than the regional average. Other countries in the region were at (Bulgaria, **Kosovo, Macedonia**) or below (**Albania, Bosnia**) average. More positively, **Albania and Bosnia** both showed higher deposit growth in 2009 than 2008, signalling a positive development in resource mobilization after the global financial crisis.

- EURASIA: Deposit growth in EURASIA averaged 26 percent for 2007-09, but like the other regions showed year-on-year declines symptomatic of the economic downturn in the region. Deposit growth was strong in all countries on average, but contracted in **Azerbaijan, Moldova and Ukraine** in 2009, with the level of decline in Ukraine serious at nearly 9 percent in 2009. (Only **Montenegro** experienced a steeper decline in deposits in 2009 among all countries under review.) **Belarus** and Russia both showed strong growth averaging 32 and 28 percent, respectively, for the period, including reasonably high growth in 2008-09. **Armenia and Georgia** also showed growth of 26 and 24 percent, respectively, despite shrinking to single-digit growth in 2008 (**Armenia**) or 2009 (**Georgia**). Likewise, in Kazakhstan, deposit growth was strong in all three years (2007-09), averaging 29 percent for the period. It is encouraging for Kazakhstan that deposits grew in 2009 despite problems faced by the banks with NPLs, CARs and serious losses. In Mongolia, deposits declined in 2008, but rebounded strongly in 2009 and showed overall growth from 2007-09 of 27.4 percent.

4.9. Foreign Exchange Deposits/Total Deposits

Data on the foreign exchange (FX) portion of deposits indicates the degree of public confidence in the local currency and domestic banking system, potential volatility of capital flows, and exchange rate policy, all of which directly impact and reflect competitiveness. The figures show high FX deposits in CEE SOUTHERN TIER countries (52.6 percent) and EURASIA (53.4 percent), with comparatively low levels in the CEE NORTHERN TIER countries (25.9 percent). PFS Beneficiary countries have higher levels in their respective regions than the norm, raising questions about public confidence in these countries.

In Korea, foreign exchange deposits are low and relatively stable, averaging 9.1 percent. They have been as high as 11.5 percent in 2009, still low and a reflection of confidence in the local currency. However, the year before, FX deposits were less than 5 percent of total.



In general, the following trends and observations are made regarding FX deposits:

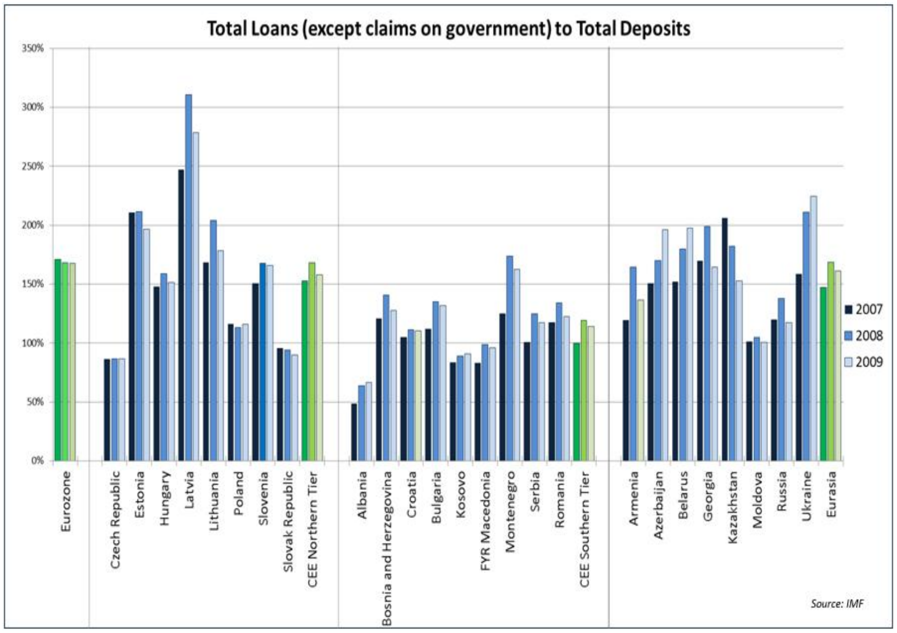
- *CEE NORTHERN TIER*: FX deposits are small as a share of total deposits in this region, averaging only 25.9 percent in 2007-09. The ratio has declined year on year since 2008. Apart from the Czech Republic, there are limited foreign exchange-denominated deposits[23].

- *CEE SOUTHERN TIER*: The region's FX deposits average for 2007-09 was 52.6 percent, with declines year on year throughout the period. The PFS Beneficiary countries of the region were higher than this, at about 59.1 percent of total. **Macedonia** (79.1 percent) and **Serbia** had the highest averages (66.4 percent), while **Albania** (42.7 percent) and **Bosnia** (48.4 percent) had lower averages. Bulgaria (47.4) and Romania (26.6 percent) were lower than the PFS Beneficiary countries. (No data for **Kosovo** or **Montenegro**.)

- *EURASIA*: The region's FX deposits were high at 53.4 percent on average from 2007-09. PFS Beneficiary countries were a bit higher at 59.1 percent. **Georgia** has the highest FX deposit figures for PFS Beneficiary countries of the region, at more than 71 percent for the 2007-09 period. **Azerbaijan** (62.3 percent), **Moldova** (66.5 percent) and **Armenia** (56.4 percent) also had fairly high averages. **Ukraine** was at 42 percent for the period, but has shown steady increases in FX deposits as a share of total since 2008, reflecting declining confidence in the local currency there. **Belarus** (36 percent) has also experienced steady year-on-year increases. Russia was reasonable at nearly 25 percent in 2009, similar to Poland and Romania.

[23] These observations may be distorted due to the limited number of countries providing data on foreign exchange-denominated deposits.

4.10. Loan-to-Deposit Ratios



Loan to deposit ratios[24] serve as a basic proxy for potential liquidity or funding mismatches that can trigger serious refinancing and portfolio restructuring problems. These ratios show high levels of lending in the 2007-09 period relative to deposits in CEE NORTHERN TIER and EURASIA, with only a modest slowdown in 2009 after increases continued through 2008. By contrast, CEE SOUTHERN TIER countries maintained reasonably modest levels of lending throughout the period, and did not exhibit the same tendency toward leverage that occurred in the other two regions. CEE NORTHERN TIER and EURASIA regions averaged nearly 160 percent loan-to-deposit ratios in 2007-09, meaning simplistically that 60 percent (or more) of loans were financed by other liabilities. Thus, in a negative scenario, any problem that banks in these regions faced in refinancing the 60 percent could potentially create a liquidity crisis for the bank. By contrast, CEE SOUTHERN TIER averaged nearly 111 percent, which is reasonably close to full matching of deposits and loans.

In Turkey, the average ratio for 2007-09 was only 76.6 percent, which indicates "surplus" liquidity and represents a safe position for the banks, albeit possibly at the expense of higher earnings. Croatia's average of nearly 109 percent was consistent with the CEE SOUTHERN TIER average.

In the Eurozone, the average ratio for 2007-09 was 168.8 percent, which represents a fairly high ratio. However, the Euro Area has deep financial markets, and refinancing is ordinarily not a problem. However, as a result of the financial crisis, European markets did tighten up, as they did elsewhere, leading to interim liquidity challenges for many institutions. On the other hand, notwithstanding the financial crisis, the depth of the markets has been demonstrated in that loan-to-deposit ratios held steady in 2009 after a slight drop in 2008.

In general, the following trends and observations are made regarding loan-to-deposit ratios:

- *CEE NORTHERN TIER*: The ratio was 160 percent for 2007-09, and as high as 168 percent in 2008. The highest ratios were found in Estonia (206 percent), Latvia (279 percent), Lithuania (184 percent), and Slovenia (161 percent). The other countries of the region were below this level, with the Czech Republic (86 percent), Slovakia (93 percent) and Poland (115 percent) all showing relative strength and stability in this regard.

- *CEE SOUTHERN TIER*: The region's loan-to-deposit ratios were stable throughout the 2007-09 period, averaging 111 percent and peaking at 119 percent in 2008. There have been three patterns in the region

[24] These are loans to companies and households, and do not include lending to government from net domestic credit figures (e.g., purchases of government securities by banks).

among PFS Beneficiary countries. **Albania** (64 percent), **Kosovo** (88 percent) and **Macedonia** (93 percent) all showed surplus liquidity on average, while **Bosnia** (130 percent) and **Serbia** (114 percent) showed reasonable ratios. However, **Montenegro** averaged 154 percent, well above the regional average. Bulgaria and Romania (about 125 percent) were slightly higher than the regional average.

- EURASIA: The loan-to-deposit ratio in EURASIA averaged 159 percent for 2007-09, and was similar in that sense to CEE NORTHERN TIER, peaking at 169 percent in 2008 before coming down in 2009. PFS Beneficiary countries are slightly higher than this on average, representing potential risk for them when faced with refinancing requirements. **Azerbaijan** (172 percent), **Belarus** (176 percent), **Georgia** (178 percent) and, above all, **Ukraine** (198 percent) were well above regional averages. By contrast, **Moldova** was virtually matched (102 percent), and **Armenia** (140 percent) was a bit high, but well below the regional average. Elsewhere in the region, Kazakhstan (180 percent) had high ratios, whereas Russia (125 percent) and Mongolia (115 percent) were in prudent ranges.

General macroeconomic sector trends show the vulnerability of many economies to slower growth in export markets, reduced tourism and inward investment, and an initial consequent decline in reserves that also reflected a culmination of cumulative and growing current account deficits in prior years of economic growth. In many countries, the loss of exports and jobs has also had a negative impact on fiscal revenues, putting pressure on fiscal balances. The general slowdown has also led to diminished net foreign direct investment. With regard to financial stability issues, the impact has been negative in most cases, with particularly adverse impacts on loan quality and bank earnings, as reflected in rising non-performing loans, increasing provisioning requirements for realized (and in some cases, anticipated) loan losses, and declining return ratios. The crisis has also triggered calls by central banks and regulatory authorities for banks to increase capital, particularly in light of the heightened risks in regional and global trends and the insufficient weights applied in risk-based calculations to many of the exposures banks have on and off their balance sheets. More positively, inflation rates and fiscal deficits have been reasonably contained, reserves have been partly replenished, and gross indebtedness has remained within serviceable parameters.

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- *GDP Growth Rates*: GDP growth rates reflected significant growth in all regions through 2008, and then major contraction in 2009. Growth rates by region were reasonably consistent in 2007-08, albeit with a drop in CEE NORTHERN TIER in 2008. By 2009, all three regions had contracted, with CEE NORTHERN TIER experiencing the sharpest drop (7.7 percent). Among the PFS Beneficiary countries, EURASIA was harder hit (6.2 percent decline) than PFS Beneficiary countries in the CEE SOUTHERN TIER (2.0 percent decline).

- *Per Capita Incomes:* Per capita incomes have shown considerable growth in CEE SOUTHERN TIER and EURASIA in recent years, but stagnation and partial decline in CEE NORTHERN TIER. In dollar terms, as measured by GDP per capita, CEE SOUTHERN TIER incomes rose from $5,653 in 2007 to $6,363 in 2010, an increase of 12.6 percent (nearly 4.2 percent per year). EURASIA has seen the same pattern, with incomes rising from $3,398 in 2007 to $3,876 in 2010, an increase of 14.1 percent (nearly 4.7 percent annually). CEE NORTHERN TIER has been hit the hardest on a percentage basis, with incomes declining from $14,958 in 2007 to $14,741 in 2010, or 1.45 percent in total and an average annualized decline of 0.5 percent. Thus, while the other regions have shown net increases (notwithstanding volatility), CEE NORTHERN TIER has shown a slight net decline and also experienced volatility. These patterns are similar to the Eurozone, albeit slightly less severe.

- *Inflation Rates*: Inflation rates have been well contained in CEE NORTHERN TIER and CEE SOUTHERN TIER, while being high in EURASIA. However, in the latter case, inflation rates in 2009-10 were well below levels in 2007-08, so EURASIA is also showing progress in moving towards increased price stability. Several countries show double-digit inflation rates for the 2007-10 period, although most of these markets have reduced inflation rates in the last two years. Only Mongolia and Uzbekistan showed double-digit inflation rates in 2010, although **Ukraine** was just below this figure. Mongolia, Tajikistan and Turkmenistan have been erratic, and **Bosnia, Macedonia**, Estonia and Latvia have shown themselves to be vulnerable at times to deflation.

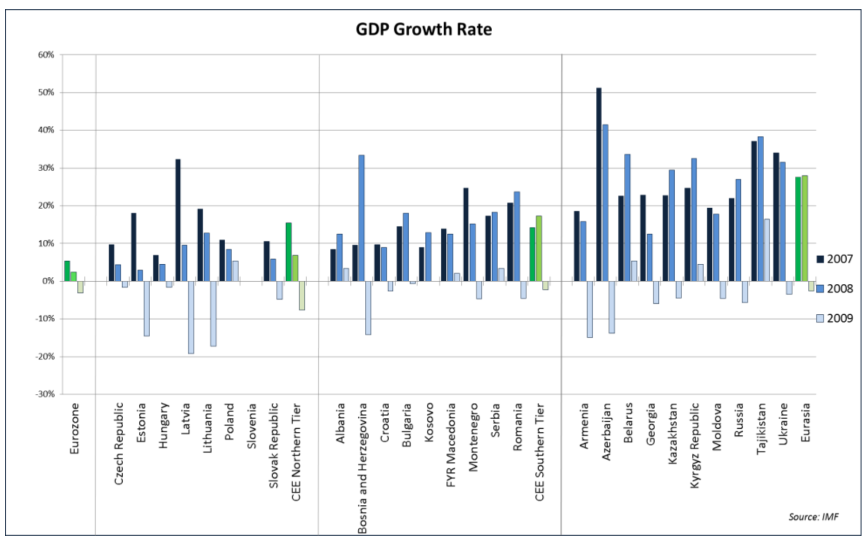
- *Fiscal Balances*: Fiscal deficits appear to be positively correlated with economic development, as the highest deficits have been in the CEE NORTHERN TIER countries due to stimulus programs to restore economic growth, while several Central Asian countries in EURASIA have shown surpluses on average from 2007-10. This pattern has since changed in Central Asia since 2009, although deficits in this region have remained lower than in the other regions. CEE SOUTHERN TIER also generated modest surpluses in 2007, and then modest deficits in 2008. However, these deficits have grown to nearly 5 percent of GDP on average since 2009, and been higher than 6 percent of GDP in CEE NORTHERN TIER since 2009. Latvia (6.7 percent) is the only country apart from Tajikistan (6.5 percent) to exceed 6 percent deficits from 2007-10, and its trend has been steadily negative year on year, in contrast to Tajikistan where deficits have declined year on year. Lithuania, Poland and Romania have all run up deficits of 5 percent or more, and Slovakia is just under (4.8 percent) due to its significant deficits in 2009-10.

- *Gross Debt*: Gross debt (Government Domestic Debt plus External Debt) has been fairly high in most countries of the region, although all regions had less total debt than the Eurozone. The data show that the regions generally have more debt in the system than Turkey (apart from EURASIA), where Gross Debt averaged 81.4 percent from 2007-09. However, Croatia has had high levels of indebtedness (121.7 percent average, rising to 137.3 percent in 2009) that have exceeded most countries.

- *Current Account Balances*: Current account deficits have been particularly severe in CEE SOUTHERN TIER, while being relatively modest in CEE NORTHERN TIER and EURASIA. CEE SOUTHERN TIER averaged 13.8 percent deficits in 2007-10, partly due to the rise in credit that financed imports. Current account deficits were particularly high in CEE SOUTHERN TIER in 2007-08, and have since come down to high but single-digit levels since. In this regard, the economic crisis has had a dampening effect on the surge of imports that were unsustainable at 2007-08 levels. Surprisingly, CEE NORTHERN TIER has generated current account surpluses since 2009, reversing fairly high deficit levels in 2007-08. However, there are diverging patterns within this group, as some countries' surpluses (e.g., Baltic states, Hungary) are linked more to spending constraints, with other countries managing the deficits reasonably well. EURASIA has been fairly consistent over the last four years, and its deficits have averaged 1.8 percent, although this is skewed by surpluses in **Azerbaijan**, Russia, Uzbekistan and Turkmenistan. The other countries of the EURASIA region show fairly high deficits, with the PFS Beneficiary countries averaging 4.4 percent deficits for the period.

- *Gross Reserves*: Gross reserves as a share of GDP declined in all regions in 2008 and then rebounded in 2009. This was partly due to IMF loans as well as reduced current account deficits. However, they remain particularly low as a share of External debt in CEE NORTHERN TIER countries, while being higher in EURASIA and CEE SOUTHERN TIER countries. **Belarus** has the lowest level of reserves as a share of GDP (7.7 percent average in 2007-09, and less than 10 percent in 2009). However, as a share of External Debt, its reserves (23.8 percent on average in 2007-09) are higher than in four countries in the CEE NORTHERN TIER (three Baltic states and Hungary), Kazakhstan and **Montenegro**. Thus, reserves in these six countries are particularly low relative to External debt levels.

- *Net Foreign Direct Investment*: As a share of GDP, net Foreign Direct Investment (FDI) has shown strength in the CEE SOUTHERN TIER (9.7 percent average in 2007-09), weakness in the CEE NORTHERN TIER (2.1 percent), and moderation in EURASIA (5.0 percent). In both regions, PFS Beneficiary countries have been consistent with (CEE SOUTHERN TIER) or exceeded (EURASIA) their regional averages.



4.11. GDP Growth Rates

GDP growth rates reflected significant growth in all regions through 2008, and then major contraction in 2009. Growth rates by region were reasonably consistent in 2007-08, albeit with a drop in CEE NORTHERN TIER in 2008. By 2009, all three regions had contracted, with CEE NORTHERN TIER experiencing the sharpest drop (7.7 percent). Among the PFS Beneficiary countries, EURASIA was harder hit (6.2 percent decline) than PFS Beneficiary countries in the CEE SOUTHERN TIER (2.0 percent decline).

Turkey weathered the storm reasonably well, registering very modest but positive growth in 2009 of 0.2 percent after 12 percent growth on average in 2007-08. Croatia experienced a 2.7 percent decline in 2009, which was slightly higher than the CEE SOUTHERN TIER average, following 9.3 percent growth on average in 2007-08.

In the advanced economies, there was a slowdown. This was reflected in the Eurozone, where GDP growth was 5.4 percent in 2007, and then dropped down to 2.5 percent in 2008 and 3.1 percent in 2009.

In general, the following trends and observations are made regarding GDP growth rates:

- *CEE NORTHERN TIER*: GDP growth averaged 4.4 percent from 2007-09 in the region, with strong growth in 2007-08 followed by a 7.7 percent decline in 2009. However, this regional average for 2009 is heavily skewed by the small economies of the three Baltic states, where Estonia (14.6 percent decline), Latvia (19.2 percent decline) and Lithuania (17.2 percent decline) were all battered after double-digit growth in 2007-08. Other countries in the region showed growth (Poland), modest declines (Czech Republic, Hungary), or declines (Slovakia, Slovenia) that were deep but less severe than in the Baltics.

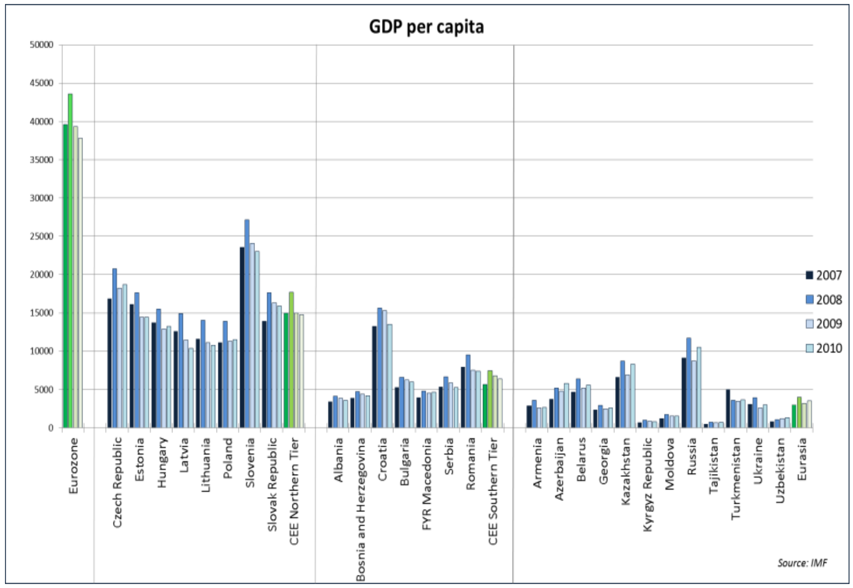
- *CEE SOUTHERN TIER*: The region's GDP growth rate was very high at about 15.8 percent in 2007-08, and then experienced a contraction in 2009 of 2.2 percent. **Albania** (3.4 percent), **Macedonia** (2.1 percent), and **Serbia** (3.4 percent) showed positive growth in all three years, whereas **Bosnia** (negative 14.1 percent), Bulgaria (negative 0.7 percent), **Montenegro** (negative 4.7 percent) and Romania (negative 4.5 percent) all experienced GDP declines in 2009. These were particularly severe in **Bosnia** at 14.1 percent. Nonetheless, all countries of the region experienced positive growth on average for 2007-09, ranging from a low of 8.2 percent in **Albania** to a high of 13 percent in **Serbia** and 13.3 percent in Romania. Data for **Kosovo** showed positive growth of 10.9 percent in 2007-08, but were not available for 2009.

- *EURASIA*: GDP growth in EURASIA averaged 16.2 percent for 2007-09, but contracted in 2009 (negative 1.0 percent) after very strong growth (24.8 percent) in 2007-08. Among PFS Beneficiary countries, growth was slightly higher than the regional average in 2007-08 (26.8 percent), but fell more precipitously in 2009 (negative 6.2 percent). Among the PFS Beneficiary countries, only **Belarus** (5.4 percent) showed growth in 2009. **Armenia, Azerbaijan, Georgia, Moldova** and **Ukraine** all experienced negative growth, ranging from a low of negative 3.5 percent in **Ukraine** to a high of negative 14.9 percent in **Armenia**. (This pattern was also true in Russia.) However, all six PFS Beneficiary countries averaged positive growth for 2007-09 (as did Russia), from a low of 6.5 percent in **Armenia** to a high of 26.3 percent in **Azerbaijan**. The Central Asian countries all showed growth in 2007-09 apart from Kazakhstan in 2009.

4.12. Per Capita Incomes

Per capita incomes have shown considerable growth in CEE SOUTHERN TIER and EURASIA in recent years, but stagnation and partial decline in CEE NORTHERN TIER. In dollar terms, as measured by GDP per capita, CEE SOUTHERN TIER incomes rose from $5,653 in 2007 to $6,363 in 2010, an increase of 12.6 percent (nearly 4.2 percent per year), although these incomes have declined in 2009-10. PFS Beneficiary countries in the region have followed the same trend, with a significant increase in 2008 and then declines in 2009-10. EURASIA has seen the same pattern, with incomes rising from $3,398 in 2007 to $3,876 in 2010, an increase of 14.1 percent (nearly 4.7 percent annually). PFS Beneficiary countries are below the dollar income figures for the EURASIA region, but experienced an increase in 2010 after a fairly steep decline in 2009. CEE NORTHERN TIER has been hit the hardest on a percentage basis, with incomes declining from $14,958 in 2007 to $14,741 in 2010, or 1.45

percent in total and an average annualized decline of 0.5 percent. Thus, while the other regions have shown net increases (notwithstanding volatility), CEE NORTHERN TIER region has shown a slight net decline. These patterns are similar to the Eurozone, albeit slightly less severe.



As with most countries, Turkey increased incomes in 2008, and then experienced declines thereafter. However, by comparison with other countries, Turkey has weathered the storm reasonably well, registering positive income growth from $9,422 in 2007 to $10,207 in 2010. This constitutes an 8.8 percent increase, or 2.8 percent annualized. Croatia did not fare as well, with incomes in 2007 of $13,210 rising in 2008-09 and then dropping down again to $13,528. This reflects volatility, and like Turkey, positive growth but at lower levels: 2.4 percent for 2008-10, or 0.8 percent annualized growth.

In the Eurozone, there was a significant slowdown in GDP growth and with it, a decline in earnings. Incomes declined from $39,618 in 2007 to $37,764 in 2010. This translates into a net decline of 4.7 percent, or negative 1.6 percent per year.

In general, the following trends and observations are made regarding GDP per capita:

- *CEE NORTHERN TIER*: Per capita incomes have declined in this region. In particular, incomes have fallen in Estonia, Latvia, Lithuania and Hungary, with a modest decline as well in Slovenia. The Czech Republic, Poland and Slovakia have all registered net increases in per capita incomes.

- *CEE SOUTHERN TIER*: The region's per capita incomes have increased on a net basis since 2007, rising in 2008 and then falling in 2009-10. **Albania, Bosnia**, Bulgaria and **Macedonia**) have experienced net increases, whereas **Serbia** and Romania have seen declines. (No data for **Kosovo** or **Montenegro**.)

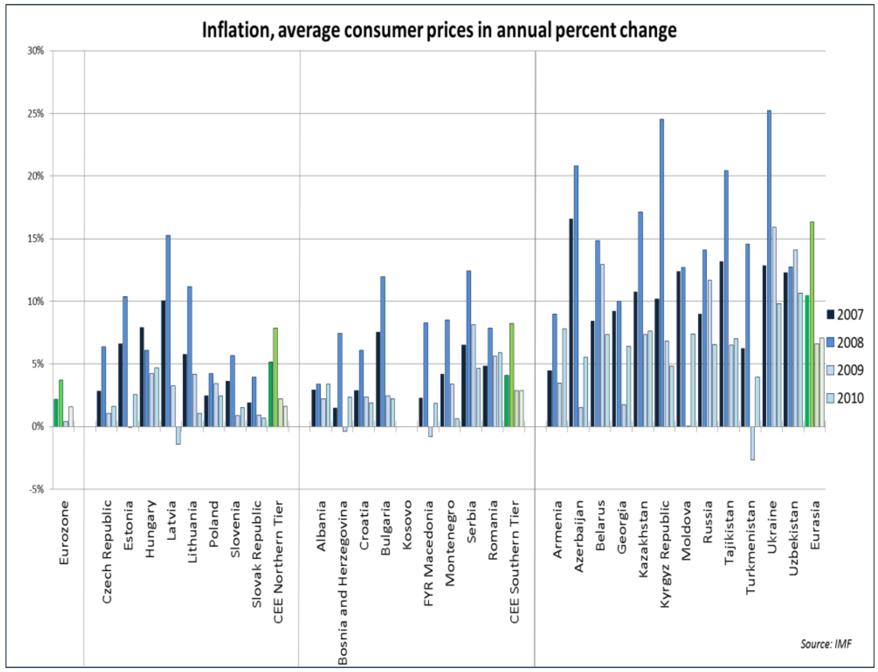
- *EURASIA*: Per capita incomes have grown in this region on a net basis since 2007, rising in 2008, falling the year after, and then rising again in 2010. **Azerbaijan**, **Belarus, Georgia** and **Moldova** have all seen growth since 2007 on a net basis, whereas **Armenia** and **Ukraine** have experienced net declines. growth, ranging from a low of negative 3.5 percent in **Ukraine** to a high of negative 14.9 percent in **Armenia**. Russia and Central Asian economies have also experienced a net increase in incomes since 2007 apart from Turkmenistan, where incomes have declined nearly 22 percent since 2008.

4.13. Inflation Rates

Inflation rates have been well contained in CEE NORTHERN TIER and CEE SOUTHERN TIER, while being high in EURASIA. However, in the latter case, inflation rates in 2009-10 were well below levels in 2007-08, so progress towards price stability is evident in EURASIA as well. Several countries show double-digit inflation rates for the 2007-10 period, although most of these markets have reduced inflation rates in the last two years. Only

Mongolia and Uzbekistan showed double-digit inflation rates in 2010, although **Ukraine** was just below this figure.

Higher inflation rates in some countries relates to growth, such as in Turkey, where the average inflation rate for 2007-10 was 8.5 percent during a period of 8 percent GDP growth. This is also found in certain resource-rich countries such as **Azerbaijan** and Mongolia, although not in all such markets (e.g., Russia, Kazakhstan).



The Eurozone average was 2 percent for 2007-10, and has averaged only 1 percent in 2009-10. This largely reflects the strict policy of the European Central Bank in ensuring there is price stability in the Euro Area.

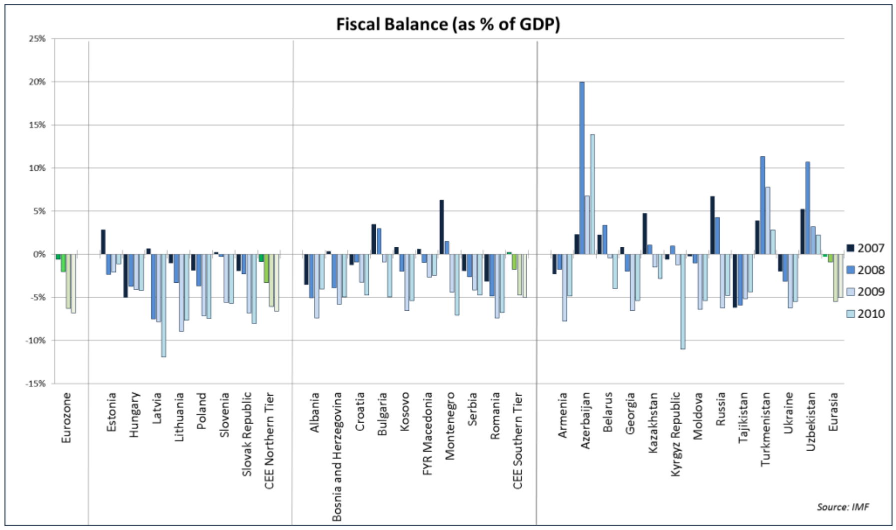
In general, the following trends and observations are made regarding inflation rates:

- *CEE NORTHERN TIER*: Inflation averaged 4.2 percent from 2007-10 in the region, and was less than 2 percent on average in 2009-10. Thus, the slowdown in the global economy has been accompanied by lower inflation rates in the region, even if they have generally been twice inflation rates in the Eurozone year on year. The Czech Republic, Poland, Slovakia and Slovenia have shown the most consistency, stability and discipline, as their rates have been below the regional average and generally in the 2-3 percent range. However, the other countries have been above the average, with very high rates in the Baltics in 2007-08. Hungary has also been above the regional average, at 5.7 percent. However, Hungary has experienced less volatility in its rates when compared with rates in the Baltics.

- *CEE SOUTHERN TIER*: The region's inflation rate was similar to CEE NORTHERN TIER, at 4.5 percent for the 2007-10 period. Likewise, inflation rates have come down in 2009-10 from earlier levels that were similar to CEE NORTHERN TIER rates on average. **Serbia**, Bulgaria and Romania were above the regional average, with **Serbia** having the highest inflation rate, at 7.9 percent. However, inflation rates have come down there since 2009. **Albania, Bosnia, Macedonia and Montenegro** have all been below the regional average, although apart from **Montenegro**, the first three showed increases in the inflation rate in 2010 after declines in 2009. **Bosnia and Macedonia** experienced deflation in 2009, with rates turning positive in 2010. (No data for **Kosovo**.)

- *EURASIA*: Inflation rates in the region were nearly 10 percent on average from 2007-10, including the PFS Beneficiary countries, with particularly high rates in 2007-08 dropping to single digits in 2009-10. **Armenia, Georgia and Moldova** have been below the regional average, in the 6-8 percent range, whereas **Azerbaijan, Belarus**, Russia, **Ukraine** have all experienced double-digit inflation rates on average. **Ukraine** in particular has had serious problems, averaging nearly 16 percent for 2007-10, the highest among all the countries under review. More recently, the other countries have brought inflation rates down, particularly in **Azerbaijan** where rates have averaged 3.5 percent in 2009-10. The average for EURASIA is higher than the other regions due to Central Asia, where inflation rates averaged 10.8 percent from 2007-10. This is largely skewed by 19.4 percent rates in Central Asia in 2008. Turkmenistan has the lowest inflation rates in the region, averaging 5.5 percent for 2007-10, although its rates have shown considerable volatility year on year. The Kyrgyz Republic, Kazakhstan and Tajikistan have brought inflation rates down to single digits in 2009-10 after double-digit inflation in prior years. However, Uzbekistan continues to struggle with double-digit inflation rates which averaged 12.4 percent for 2007-10, the highest in the region apart from Mongolia, which has also shown high average inflation rates and considerable volatility year on year.

4.14. Fiscal Balances



Fiscal deficits appear to be positively correlated with economic development, as the highest deficits have been in the CEE NORTHERN TIER countries due to stimulus programs to restore economic growth, while several Central Asian countries in EURASIA have shown surpluses on average from 2007-10. This pattern has since changed in Central Asia since 2009, although deficits in this region have remained lower than in the other regions. CEE SOUTHERN TIER also generated modest surpluses in 2007, and then modest deficits in 2008. However, these deficits have grown to nearly 5 percent of GDP on average since 2009, and been higher than 6 percent of GDP in CEE NORTHERN TIER since 2009.

By contrast, Turkey has shown reasonable deficits on average since 2007 at 3.3 percent. Croatia has likewise shown discipline by maintaining an average 2.5 percent deficit since 2007, albeit about 4 percent since 2009.

In the Eurozone, fiscal deficits have averaged nearly 4 percent, which is higher than the Maastricht Treaty requirement of a 3 percent maximum. The Eurozone showed a high level of discipline in 2007-08 when fiscal deficits were about 1.3 percent on average. In 2009-10, these deficits rose to an average 6.6 percent as governments sought to stimulate growth while containing inflation rates (as per the low inflation policy of the European Central Bank).

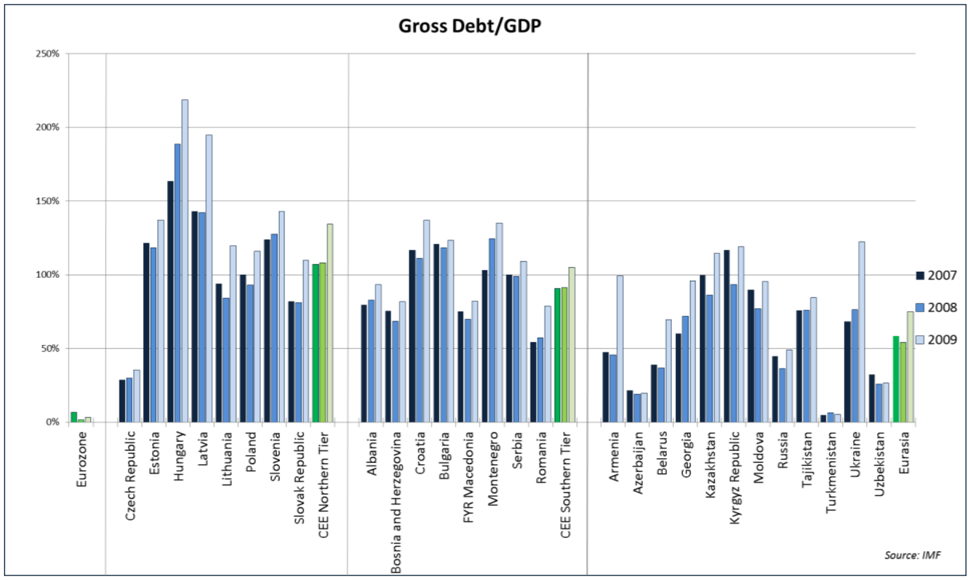
In general, the following trends and observations are made regarding fiscal balances:

- *CEE NORTHERN TIER*: Fiscal deficits averaged 4.2 percent from 2007-10 in the region, with deficits deepening in 2009-10 in response to the worsened economy. There has been steady erosion on this front, with very mild deficits in 2007 nearly quadrupling in 2008 and then doubling again by 2010. About half the countries have been at or below the average for 2007-10, with Estonia and Slovenia showing a high level of fiscal discipline. However, apart from Estonia, these countries have experienced deeper deficits in 2009-10. Meanwhile, Latvia and Lithuania have run very high deficits, with Latvia in particular running up deep deficits averaging about 9 percent since 2008, and having the deepest fiscal deficits on average among all countries under review. Poland, and Slovakia have also had significant deficits in 2009-10, and their averages for the 2007-10 period have been above the regional average.

- *CEE SOUTHERN TIER*: The region's fiscal deficits for 2007-10 have been a reasonable 2.8 percent. Apart from **Albania** with a 5 percent average deficit for the 2007-10 period, the region has shown fiscal discipline. **Bosnia, Macedonia and Montenegro** generated fiscal surpluses in 2007, and **Montenegro** did so again in 2008, bringing down their averages for the 2007-10 period. **Montenegro's** average is less than 1 percent, and **Macedonia's** deficits have averaged 1.4 percent. **Bosnia, Kosovo and Serbia** have had deficits of about 3.5 percent, slightly higher than the regional norm, but lower than deficits in CEE NORTHERN TIER and most of the EU. The only real negative is that fiscal deficits have increased in 2009-10 across the board in response to the economic crisis, and will need to be brought down once the economy shows signs of stabilizing. This is particularly the case in **Albania,** where gross debt levels are at about 60 percent of GDP.

- *EURASIA*: The fiscal profile of the region is close to balance, although the PFS Beneficiary countries in the region showed very modest average deficits of 0.65 percent from 2007-10. This is largely skewed by the 10.7 percent surplus generated in oil-rich **Azerbaijan**. However, the other countries of the region have also shown reasonable or strong discipline, with **Belarus** generating a modest surplus, Russia being flat, and **Georgia and Moldova** keeping deficits at about 3.3 percent on average. Even **Ukraine** has kept deficits at 4.2 percent despite other macroeconomic and structural problems. **Armenia** has been at about 4.2 percent on average as well. The negative in the region is that several of these countries showed deeper deficits in 2009-10, with **Armenia, Georgia, Moldova,** Russia and **Ukraine** all averaging 5-6 percent deficits in 2009-10. Fortunately, the region has relatively low gross debt levels, so it should be able to absorb the deficits during the economic slowdown. This is particularly the case in Russia which is benefiting from the rise in global oil prices. Elsewhere in EURASIA, Central Asia actually generated a 0.2 percent surplus from 2007-10. Turkmenistan and Uzbekistan have generated major surpluses averaging 6.5 and 5.3 percent, respectively, and Kazakhstan generated a 0.4 percent surplus for the period. All three countries' economies are benefiting from the rise in commodity prices in international markets. Among the other countries of the region, only Tajikistan has generated high deficits, averaging 5.4 percent in 2007-10. However, unlike most countries, Tajikistan has been steadily reducing its deficits each year. Mongolia and the Kyrgyz Republic had deficits of 3 percent or less for the period, although the trend is worsening in the Kyrgyz Republic where deficits reached 11 percent of GDP in 2010.

4.15. Gross Debt



Gross debt (Government Domestic Debt plus External Debt) has been fairly high in most countries of the region, although all regions had less total debt than the Eurozone. While Government Domestic debt has been kept at reasonable levels in most cases, total (Gross) debt has been high given their additional levels of External debt.

The data show that the regions generally have more debt in the system than Turkey (apart from EURASIA), where Gross debt averaged 81.4 percent from 2007-09. However, Croatia has had high levels of indebtedness (121.7 percent average, rising to 137.3 percent in 2009) that have exceeded most countries' levels apart from Hungary, Estonia, Latvia, **Montenegro** and Slovenia.

In the Eurozone, Gross debt is high, averaging 192 percent of GDP from 2007-10. Thus, Gross debt is nearly two times GDP on average.

In general, the following trends and observations are made regarding Gross debt. These are discussed more specifically by domestic and external debt below.

- *CEE NORTHERN TIER*: Gross debt averaged 128.7 percent from 2007-09, about three quarters of which was External. There was a spike in 2009, leaving the region with Gross debt at 1.5 times total GDP. Hungary (190 percent) and Latvia (160 percent) are particularly indebted, above regional levels, and in the case of Hungary, just about at very high Eurozone levels of indebtedness.

- *CEE SOUTHERN TIER*: The region's Gross debt figures approximated 95.8 percent of GDP (slightly lower in the PFS Beneficiary countries), with an increase in 2009. PFS Beneficiary countries above the CEE SOUTHERN TIER average of 105 percent in 2009 include **Montenegro** (135 percent) and **Serbia** (109 percent). (Bulgaria was also above the regional average in 2009. There were no data for **Kosovo.**)

- *EURASIA*: Gross debt in the region was a low 64.4 percent on average from 2007-09, and virtually the same (68.1 percent) for the PFS Beneficiary countries. However, some PFS Beneficiary countries showed increases in 2009, where the regional average increased to 77.4 percent. PFS Beneficiary countries above the regional average in 2009 were **Armenia** (99.4 percent), **Georgia** (95.8 percent), **Moldova** (95.6 percent) and **Ukraine** (122.6 percent). **Belarus** had relatively low debt (51.9 percent). Oil-rich **Azerbaijan** is a bit of an outlier, with only 32 percent Gross debt to GDP. A low level of Gross debt is a fairly consistent characteristic across the board in resource-rich countries, as seen elsewhere in EURASIA. For example, Russia and Kazakhstan also show relatively low levels of Gross debt (60 percent or less). However, commodities are not the sole determinant. The Kyrgyz Republic and Tajikistan also have low debt levels, and neither country is resource-rich.

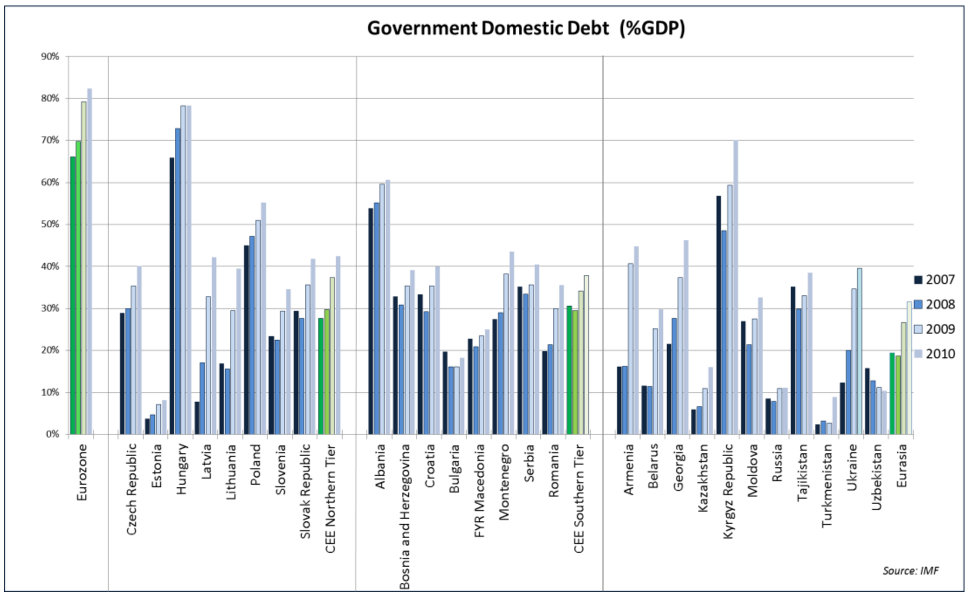
Government Domestic Debt

Government Domestic Debt-to-GDP ratios have been kept at reasonable levels among most countries. Only Hungary and the Kyrgyz Republic have levels approaching the high Eurozone levels of Government debt, although **Albania** is also showing fairly high levels. Government Domestic debt levels have been highest in the CEE NORTHERN TIER countries (34.3 percent), although CEE SOUTHERN TIER is virtually the same at 33 percent. EURASIA debt levels were only 24.1 percent (27.2 percent for the PFS EURASIA Beneficiary countries) on average from 2007-10. All regions are showing steady increases year on year.

The data show that the regions have less debt in the system than Turkey, where Government Domestic debt averaged 42 percent from 2007. Croatia has been similar to CEE NORTHERN and SOUTHERN TIER, with these debt levels at 34.5 percent (40 percent in 2010).

In the Eurozone, Government Domestic debt averaged 74 percent of GDP from 2007-10, which is very high when compared with the CEE and EURASIA regions.

In general, the following trends and observations are made regarding Government Domestic debt:



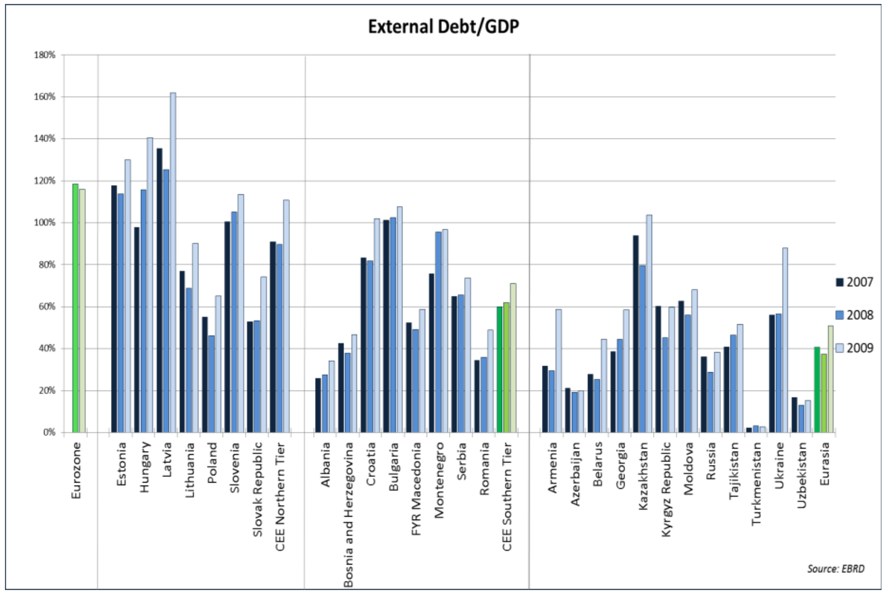
- *CEE NORTHERN TIER*: Government Domestic debt averaged 34.3 percent from 2007-10 in the region, although these figures have increased each year since 2008. Estonia has one of the lowest debt ratios in the world, at only 5.9 percent of GDP. Latvia, Lithuania, and Slovenia have ratios approximating 25-27 percent for the period, although they have risen in recent years. The Czech Republic and Slovakia (both 33.6 percent) are slightly below the regional average. Only Poland (49.6 percent) and Hungary (73.8 percent) were above the regional average, with Hungary having the highest Government Domestic debt levels of all countries under review.

- *CEE SOUTHERN TIER*: The region's Government Domestic debt figures are very similar to CEE NORTHERN TIER, averaging 33.0 percent of GDP for 2007-10. Apart from **Albania**, where the ratio averaged 57.3 percent for the period and went above 60 percent in 2010, CEE SOUTHERN TIER countries are generally about 35-36 percent (**Bosnia, Montenegro, Serbia**) or below (**Macedonia** at 23 percent). All countries have shown increases in recent years, but remain well below the 60 percent limit apart from **Albania**. Bulgaria is very low, at 17.5 percent on average for 2007-10. Romania is also low at 26.6 percent. (No data for **Kosovo.**)

- *EURASIA*: Government Domestic debt in the region was only 24.1 percent on average from 2007-10, and 27.2 percent for the PFS Beneficiary countries. **Azerbaijan** (9.3 percent), Russia (9.6 percent), and **Belarus** (19.5 percent) have debt levels below the regional average, while **Ukraine** (26.6 percent), **Moldova** (27.1 percent) and **Armenia** (29.4 percent) are at or approximate the regional average. Only **Georgia** is above the average (33.2 percent), and its debt levels have increased each year since 2008, as have debt levels in **Armenia, Belarus, Moldova and Ukraine**. By contrast, Central Asian countries have had the lowest Government Domestic debt at about 24 percent. Only the Kyrgyz Republic has comparatively high levels of debt, averaging 58.7 percent for 2007-10 and reaching 70 percent in 2010,higher than all other countries under review except Hungary. By contrast, Turkmenistan (4.3 percent) has the lowest ratio of all countries under review, and Kazakhstan (9.9 percent) and Uzbekistan (12.5 percent) also have low levels that are well below the regional average. Tajikistan's debt levels averaged 34.1 percent for the period, similar to CEE NORTHERN and SOUTHERN TIER averages.

External Debt

External debt appears to rise with increasing levels of economic development. External debt is highest in the CEE NORTHERN TIER countries (97.1 percent of GDP), not too far below the Eurozone average of 118.1 percent and three times Government Domestic debt. CEE SOUTHERN TIER External debt is about 64.4 percent of GDP, about two times Government Domestic debt. In EURASIA, External debt was about 42.9 percent of GDP, also about two times Government Domestic debt. Year-on-year patterns show growth across regions.



Turkey has kept its External debt at reasonably low levels, averaging 40 percent for 2007-09. By contrast, Croatia's figures are about 89 percent, closer to the CEE NORTHERN TIER.

In the Eurozone, External debt approximated 118 percent of 2008-10 GDP.

In general, the following trends and observations are made regarding External debt:

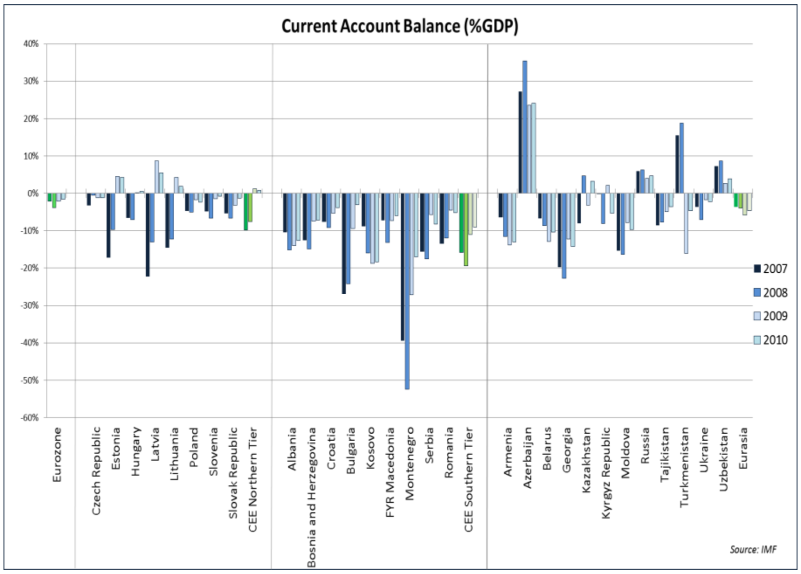
- *CEE NORTHERN TIER*: External debt averaged 97.2 percent from 2007-10 in the region, with a spike in 2009 rendering External debt equivalent to 111 percent of GDP. Latvia (140 percent), Estonia (120 percent), Hungary (118 percent) and Slovenia (106 percent) have the highest ratios, partly reflecting the slowdown in GDP. Poland (55 percent) and Slovakia (60 percent) were well below the regional average, as was Lithuania (79 percent). (No data for the Czech Republic.)

- *CEE SOUTHERN TIER*: The region's External debt figures approximated 64.4 percent of GDP, with a slight rise in 2009. While it has the highest amount of Government domestic debt, **Albania** (29.2 percent) has the lowest level of External debt as a share of GDP. **Bosnia** (42.3 percent), **Macedonia** (53.5 percent) and Romania (39.7 percent) were below the regional average, while **Serbia** (68 percent)and Montenegro (89.4 percent) were above the average. Bulgaria was the highest in the region, at 103.7 percent on average for 2007-10. (No data for **Kosovo.**)

- *EURASIA*: External debt in the region was only 42.9 percent on average from 2007-10, and virtually the same (44.8 percent) for the PFS Beneficiary countries. **Armenia** (40 percent), **Azerbaijan** (20.1 percent), **Belarus** (32.4), and Russia (34.4 percent) were all below the average, whereas **Georgia** (47.1 percent), **Moldova** (62.2 percent) and **Ukraine** (66.8 percent) were above the average. Elsewhere in EURASIA, Central Asian countries show widely divergent patterns, from a high of 92.4 percent in Kazakhstan to a low of 2.8 percent in Turkmenistan.

4.16. Current Account Balances

Current account deficits have been particularly severe in CEE SOUTHERN TIER, while being relatively modest in CEE NORTHERN TIER and EURASIA. CEE SOUTHERN TIER averaged 13.8 percent deficits in 2007-10, partly due to the rise in credit that increased imports. Current account deficits were particularly high in CEE SOUTHERN TIER in 2007-08, and have since come down to high but single-digit levels since. In this regard, the economic crisis has had a dampening effect on the surge of imports that were unsustainable at 2007-08 levels. Surprisingly, CEE NORTHERN TIER has generated current account surpluses since 2009, reversing fairly high deficit levels in 2007-08. However, there are diverging patterns within this group, as some countries' surpluses (e.g., Baltic states, Hungary) are linked more to spending constraints, with other countries managing the deficits reasonably well. EURASIA has been fairly consistent over the last four years and deficits have averaged 1.8 percent, although this is skewed by surpluses in **Azerbaijan**, Russia, Uzbekistan and Turkmenistan. The other countries of the EURASIA region show fairly high deficits, with the PFS Beneficiary countries averaging 4.4 percent deficits for the period.



Turkey has generated current account deficits of about 4.8 percent on average since 2007. Croatia's deficits have been fairly high at 6.5 percent, although they have come down since 2009.

In the Eurozone, current account deficits were fairly low at 2.5 percent on average from 2007-10. These deficits have come down since 2009, and reflect a combination of less importation as incomes have declined, and a resurgence of some markets' exports (e.g., Germany).

In general, the following trends and observations are made regarding current account balances:

- *CEE NORTHERN TIER*: Current account deficits averaged 3.9 percent from 2007-10 in the region, with deficits being fairly deep in 2007-08 at nearly 9 percent on average, and then leading to surpluses of about 1 percent in 2009-10. Estonia, Hungary, Latvia and Lithuania have all generated surpluses in the last two years, partly due to policies to reduce these deficits and bring consumer spending under control. Current account deficits were particularly high at about 16 percent in the three Baltic states in 2007-08. CEE NORTHERN TIER countries generally kept their deficits 4 percent or less for the period. In general, current account deficits have narrowed significantly or been transformed into surpluses since the crisis hit in 2008.

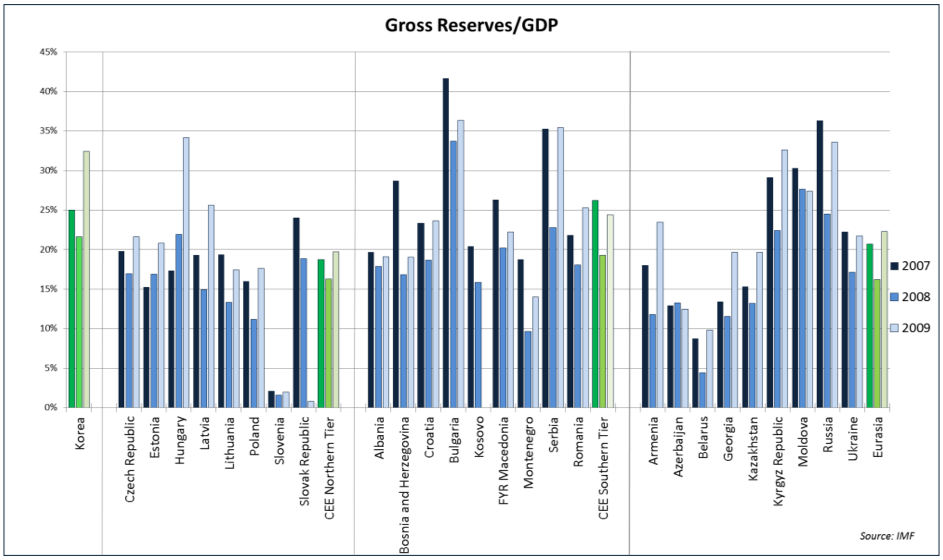
- *CEE SOUTHERN TIER*: The region's current account deficits for 2007-10 have been high at 13.8 percent, although they have come down to single digits in 2010. As with CEE NORTHERN TIER, the economic crisis has had a favorable impact on what were unsustainable deficit levels in 2007-08. Among the six countries, only **Macedonia** has incurred deficits at lower than 10 percent levels (8.4 percent from 2007-10). All other countries have had at least 10 percent current account deficits on average, with **Montenegro** particularly high at an unsustainable 34 percent. **Bosnia** (10.6 percent), **Kosovo** (15.5

percent), **Serbia** (11.8 percent) and **Albania** (13.1 percent) all showed high deficits, although they have come down since 2009 from earlier levels (except in **Kosovo**) and, in the case of **Bosnia and Serbia**, been brought down to single digit deficits. Bulgaria has also had significant challenges with current account deficits, although these have declined year on year since 2008 and were manageable at 3 percent in 2010. Romania's current account deficits averaged 8.7 percent for the 2007-10 period.

- *EURASIA*: Current account deficits in the region were only 1.8 percent on average from 2007-10, and 4.4 percent for the PFS Beneficiary countries of EURASIA. These have been very consistent year to year. However, the data are skewed by surpluses in **Azerbaijan** (27.6 percent) and, to a lesser extent, Russia (5.2 percent), Turkmenistan (3.4 percent) and Uzbekistan (5.6 percent). **Armenia** (11.2 percent), **Belarus** (9.7 percent), **Georgia** (17.2 percent), and **Moldova** (12.3 percent) all continue to face deep current account deficits. **Ukraine** has generally maintained a fairly stable current account, averaging 3.7 percent deficits that were lower than that in 2009-10. Central Asia had the lowest current account deficit averages due to the surpluses generated in 2007-08 (and beyond in three cases). More recently, current account deficits of about 4 percent of GDP have been incurred in Central Asia, with divergent patterns. Most of the average deficit is derived from Mongolia and Tajikistan, with 2007-10 average deficits of 7.7 percent and 6.2 percent, respectively. Uzbekistan (5.6 percent) and Turkmenistan (3.4 percent) have generated current account surpluses, and Kazakhstan has sustained only minor deficits on average (0.8 percent). The Kyrgyz Republic has manageable deficits of 2.9 percent, although patterns in Kyrgyz have been more volatile than in some of the other countries.

4.17. Gross Reserves

Gross reserves as a share of GDP declined in all regions in 2008 and then rebounded in 2009. This was partly due to IMF loans as well as reduced current account deficits. However, they remain particularly low as a share of External debt in CEE NORTHERN TIER countries, while being higher in EURASIA and CEE SOUTHERN TIER countries. **Belarus** has the lowest level of reserves as a share of GDP (7.7 percent average in 2007-09, and less than 10 percent in 2009). However, as a share of External debt, its reserves (23.8 percent on average in 2007-09) are higher than in four countries in the CEE NORTHERN TIER (three Baltic states and Hungary), Kazakhstan and **Montenegro**. Thus, reserves in these six countries are particularly low relative to External debt levels.



Turkey also shows comparatively low reserve levels, at less than 11 percent of 2007-09 GDP and 27.1 percent of External debt. Croatia's reserves averaged 21.9 percent of 2007-09 GDP and were about 24.7 percent of External debt. Thus, relative to External debt, these countries' reserves were generally lower than those found in the PFS Beneficiary countries.

In Korea, gross reserves average 26.3 percent in 2007-09, rising to 32.4 percent in 2009 from a low of 21.6 percent in 2008. Thus, Korea tends to have higher reserves than the CEE and EURASIA regions.

In general, the following trends and observations are made regarding reserves:

- *CEE NORTHERN TIER*: Reserves averaged 16.9 percent of GDP from 2007-09 in the region, and 17.4 percent of External debt[25]. Estonia (14.6 percent) and Latvia (14 percent) have particularly low reserves as a share of External debt on average, while Poland and Slovakia have the highest coverage ratios on average (27 percent) and Hungary and Lithuania are in between (20-21 percent coverage of External debt). More positively, reserve growth rebounded as a share of GDP in 2009, and increased in coverage of External debt.

- *CEE SOUTHERN TIER*: The region's reserves declined in 2008 as they did elsewhere, yet showed strong growth in 2009. Reserves averaged 23.3 percent of GDP for 2007-09, the highest of the three regions. As a share of External debt, reserves averaged 36.4 percent, representing higher coverage of debt than in CEE NORTHERN TIER countries. **Albania, Bosnia** and Romania have particularly higher coverage ratios above 50 percent of External debt, and **Serbia and Macedonia** are also strong in the 43-46 percent

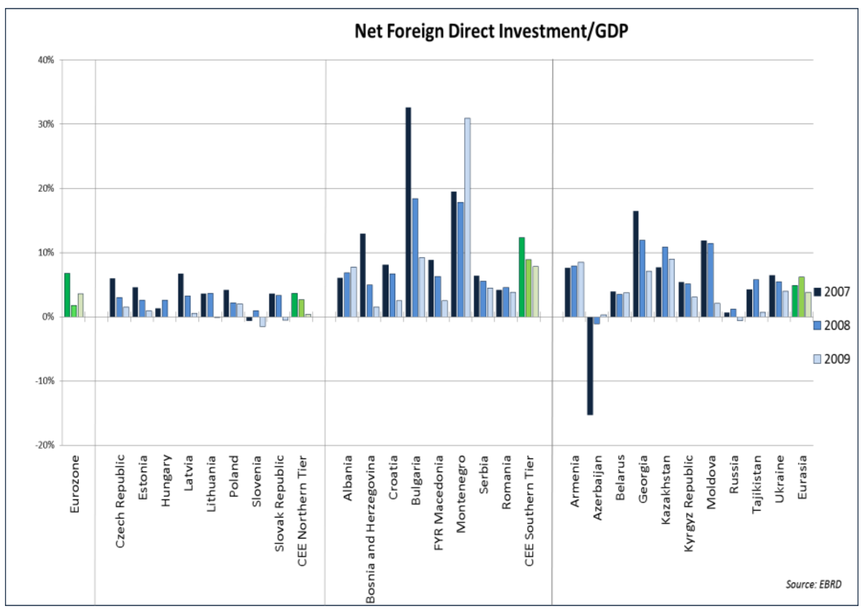
[25] These data exclude the Czech Republic and Slovenia.

range. However, **Montenegro** has low coverage averaging 16.4 percent for the period, and less than 15 percent in 2009. Bulgaria's coverage was 36 percent, just about the norm for the region. (No data for **Kosovo**.)

- *EURASIA*: Reserves to GDP approximated 20 percent in EURASIA for 2007-09, with a slightly lower ratio of 17 percent for PFS Beneficiary countries of the region. However, the region shows the highest coverage of External debt at 46.1 percent (38.5 percent for PFS Beneficiary countries). Coverage of External debt is particularly high (above 50 percent) in **Azerbaijan** (64.2 percent) and Russia (91 percent), and well covered (above 40 percent) in **Armenia** (45.7 percent) and **Moldova** (46.1 percent). **Belarus** (23.8 percent), **Georgia** (31.5 percent) and **Ukraine** (31.6 percent) all have lower coverage ratios. Elsewhere in EURASIA, Central Asia shows divergent patterns, with high coverage in the Kyrgyz Republic, moderate coverage in Mongolia, and low coverage in Kazakhstan. (No data for Tajikistan, Turkmenistan or Uzbekistan.)

4.18. Net Foreign Direct Investment

As a share of GDP, net Foreign Direct Investment (FDI) has shown strength in the CEE SOUTHERN TIER (9.7 percent average in 2007-09), weakness in the CEE NORTHERN TIER (2.1 percent), and moderation in EURASIA (5.0 percent). In both regions, PFS Beneficiary countries have been consistent with (CEE SOUTHERN TIER) or exceeded (EURASIA) their regional averages. This is a positive development that shows confidence on the part of investors in the potential earnings from investment in these countries and, in the case of CEE SOUTHERN TIER, increasing integration with the Eurozone. This also suggests that in many of the countries, investors are reasonably comfortable with investor protection, contract enforcement and related areas of the business environment. However, in many small countries, a single large investment can skew the average, as may have been the case with **Montenegro**.



By comparison, net FDI in Turkey has declined year on year, and averaged 2.1 percent for 2007-09, although this may partly reflect significant direct investment abroad by Turkish businesses. Croatia has also experienced year-on-year declines, but averaged 5.8 percent for 2007-09, lower than CEE SOUTHERN TIER, but higher than the other regions and the Eurozone.

In the Eurozone, net FDI was 4 percent for 2007-09.

In general, the following trends and observations are made regarding net FDI:

- *CEE NORTHERN TIER*: Net FDI averaged 2.1 percent of GDP from 2007-09 in the region, and was a low 0.4 percent in 2009. Slovenia has experienced net outflows (negative 0.4 percent) during the period, which may reflect outward investment into many CEE SOUTHERN TIER countries, while all other countries of the region have attracted net FDI in the 1-3.5 percent range. Latvia has the highest figures, but has experienced steady declines since 2008.

- *CEE SOUTHERN TIER*: The region's net FDI has been comparatively strong at 9.7 percent. The PFS Beneficiary countries have been slightly below the regional average, but showed increased net FDI in 2009 while there were declines on average in the region. The average is skewed by **Montenegro** (22.7 percent average, including 30.9 percent in 2009) and Bulgaria (20.1 percent, including 32.6 percent in 2007). **Albania (**6.9 percent), **Bosnia** (6.5 percent), **Macedonia** (5.9 percent), Romania (4.2 percent) and **Serbia** (5.5 percent) were all below the regional average. (No data for **Kosovo**.)

- *EURASIA*: Net FDI to GDP approximated 5 percent in EURASIA for 2007-09, with a slightly higher ratio of 5.3 percent for PFS Beneficiary countries of the region. **Azerbaijan** (negative 5.3 percent) is an aberration for the region, showing net outward investment, although this may not be surprising given its vast oil wealth. Other PFS Beneficiary countries showed net inflows ranging from a low of 3.8 percent in **Belarus** to a high of 11.9 percent in **Georgia**. Elsewhere in EURASIA, Russia (0.45 percent) showed low figures, while Mongolia (10.7 percent) and Kazakhstan (9.2 percent) showed high figures. (No data for Turkmenistan or Uzbekistan.)

5. Financial Sector Size

Most countries for which data are available seem to show about 3-5 percent of GDP is accounted for by financial services. However, the size of the financial sector in many of the countries under review is difficult to measure due to weak data on non-banking sectors.

Most countries for which data are available seem to show about 3-5 percent of GDP is accounted for by financial services. However, the size of the financial sector in many of the countries under review is difficult to measure due to weak data on non-banking sectors. In most cases, CEE NORTHERN TIER has a larger financial sector than the other regions, particularly in terms of bank credit penetration. However, its deposit mobilization relative to GDP has actually been slightly lower than in CEE SOUTHERN TIER for 2007-09, and bank capital to GDP is actually highest in Central Asia.

- *Financial Services-to-GDP*: Financial services are generally estimated to be about 3-5 percent of GDP in most of the countries under review, although very possibly less in countries not reporting financial intermediation data. This ratio is low when compared with advanced economies where the norm is estimated to be closer to 10 percent. When applying the ratios to GDP in several of the markets (Albania, Bosnia, Bulgaria, Romania, Serbia), financial services tend to be in a range of about $1,000-$2,000 per capita.

- *Deposits-to-GDP*: CEE NORTHERN TIER and CEE SOUTHERN TIER markets are fairly similar in terms of deposit mobilization relative to GDP, while EURASIA is the lowest. Among the PFS Beneficiary countries under review, **Albania** had the highest ratio, at 59 percent on average. This is an extraordinary accomplishment given the loss of confidence in the system in the late 1990s following the collapse of the pyramid scheme. The lowest ratios among PFS Beneficiary countries were in the three Caucasus countries (**Azerbaijan, Armenia, Georgia**).

- *Credit-to-GDP*: CEE NORTHERN TIER shows significantly higher credit levels than the other regions, with CEE SOUTHERN TIER lagging CEE NORTHERN TIER, followed by EURASIA. Two of the Baltic states in particular show very high ratios, with Estonia averaging 101.3 percent credit to GDP in 2007-09 and Latvia 98.7 percent. Part of the impact on the ratios in these countries has to do with declining GDP in 2009. However, in general, CEE NORTHERN TIER countries show ratios exceeding 60 percent in most cases, with the Czech Republic, Poland and Slovakia being exceptions. By contrast, apart from Bulgaria and **Montenegro**, both of which were above 70 percent, and Kosovo (28.4 percent), CEE SOUTHERN TIER averages were in the 40-60 percent range. EURASIA shows ratios generally in the 20-40 percent range apart from **Ukraine** (75 percent), which has run into very serious problems of non-performing loans. Data for Central Asia were limited to Kazakhstan (2007-09), Mongolia (2007-08) and Tajikistan (2007), where the range was 30-60 percent.

- *Bank Capital-to-GDP*: CEE SOUTHERN TIER had the highest average (about 11.6 percent), slightly higher than CEE NORTHERN TIER (11.1 percent) and higher than EURASIA (about 10 percent). PFS Beneficiary countries in CEE SOUTHERN TIER and EURASIA had bank capital slightly below their respective regional norms.

- *Stock Market Capitalization-to-GDP*: CEE NORTHERN TIER countries have shown development of an equities market in recent decades. However, given the myriad problems of the markets and general business environment, combined with the small size of many of these markets, stock markets have not taken off in any region. However, some countries have had success, namely Kazakhstan and Poland.

- *Gross Insurance Premium Revenues-to-GDP*: Gross insurance premiums approximate 1.9 to 2.9 percent of GDP in the three regions under review for which data are available, although the average would be lower if data from the other 15 countries were included[26]. On a regional basis, based on the available data, CEE NORTHERN TIER showed 2.9 percent in 2009, followed by CEE SOUTHERN TIER (2.2 percent) and EURASIA (1.8 percent). **Serbia** and **Ukraine** are the only two PFS Beneficiary countries with penetration ratios at or about the 2 percent of GDP mark. Many of the countries have greater insurance penetration than Turkey, but lag Croatia and the Eurozone.

5.1. Financial Services-to-GDP

Quantifying financial services as a share of GDP is difficult because of the lack of data in some countries, and differing classifications in others. For instance, in the EU and many of the countries under review, financial intermediation or services are grouped with real estate and rental activity, whereas other countries separate these data. However, based on the data presented, financial services seem to account for about 3-5 percent of GDP in most countries, which is low when compared with advanced economies where the norm is estimated to be closer to 10 percent. When applying these ratios to GDP in several of the markets (**Albania, Bosnia**, Bulgaria, Romania, **Serbia**), financial services tend to be in a range of about $1,000-$2,000 per capita.

Turkey reported 3.8 percent financial services to GDP on average from 2007-10. Croatia reported 5.4 percent in 2007, but provides no data beyond this date.

In the Euro Area, 28.6 percent of GDP is accounted for by financial services, real estate and rental activity. However, as this includes real estate and other rentals, it is unclear how this compares with the narrower measures. In all likelihood, the narrower measure would show financial services to approximate 10 percent of GDP, depending on the country, with key financial centers like the UK and Germany potentially showing higher ratios, and other countries below the 10 percent mark.

In general, the following observations are made regarding financial services:

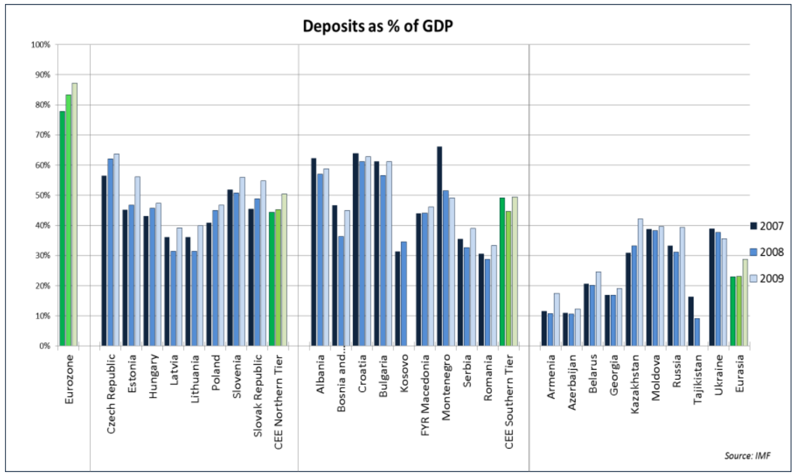
- *CEE NORTHERN TIER*: Financial services in the region approximated 4.8 percent of GDP from 2007-09. This is well below the average for the Euro Area, although the latter's definition includes more than just financial services. In general, the region's financial services ratio was fairly constant during the period.

- *CEE SOUTHERN TIER*: Only two countries (**Serbia and Bosnia**) have usable data for this ratio. **Bosnia's** ratio averaged 4.2 percent from 2007-09, and **Serbia's** was about 3.2 percent for 2007-08. (**Macedonia** is excluded because the ratio appears to be an outlier at about 14.4 percent, which would be about $4,500 per capita. It is more likely that **Macedonia's** ratio is closer to regional norms, such as 4-5 percent.)

[26] Including these countries would bring down the regional averages for CEE SOUTHERN TIER and EURASIA.

- *EURASIA*: Financial services are reported to be higher in EURASIA than the other regions, although this is very likely distorted by **Georgia's** average ratio of 9.4 percent. The other markets for which data are available (**Armenia, Azerbaijan, Belarus, Moldova**, Russia, **Ukraine**) average about 4 percent, with **Azerbaijan** the lowest and **Moldova** the highest. **Belarus**, Russia and **Ukraine** are comparable, although data for all three are limited to just one or two years. Central Asia also shows financial services to be about 4-5 percent of GDP, with Kazakhstan, Mongolia, and Uzbekistan reporting data for at least two years.

5.2. Deposits-to-GDP



CEE NORTHERN TIER and CEE SOUTHERN TIER markets are fairly similar in terms of deposit mobilization relative to GDP, while EURASIA is the lowest. Among the PFS Beneficiary countries under review, **Albania** had the highest ratio, at 59 percent on average. This is an extraordinary accomplishment given the loss of confidence in the system in the late 1990s following the collapse of the pyramid scheme. The lowest ratios among PFS Beneficiary countries were in the three Caucasus countries: **Azerbaijan, Armenia, and Georgia**. (Kyrgyz Republic, Tajikistan, Turkmenistan and Uzbekistan did not report data, and may be below Caucasus levels).

Turkey reported 45.9 percent deposits to GDP from 2007-09. Croatia reported 62.7 percent from 2007-09, the highest level among countries under review.

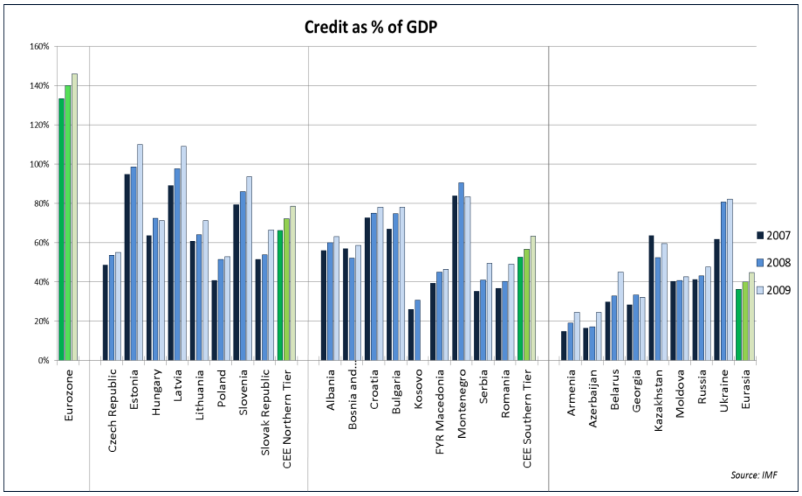
In the Eurozone, deposits averaged nearly 83 percent of GDP in 2007-09.

In general, the following trends and observations are made regarding deposits to GDP:

- *CEE NORTHERN TIER*: Deposits to GDP in the region ranged from 44.4 percent in 2007 to 50.5 percent in 2009. The share of deposits increased in 2009 due to the slowdown in the economy, not due to increased deposits. Deposit-to-GDP ratios in this region are highest in the Czech Republic (61 percent) and Slovenia (53 percent). At the other end of the spectrum, Latvia and Lithuania only have about 35-36 percent deposits to GDP. The other countries in the region (Estonia, Hungary, Poland, Slovakia) approximate the regional average.

- *CEE SOUTHERN TIER*: The region shows a range of deposit-to-GDP ratios, with **Albania** and Bulgaria approaching 60 percent on average while **Kosovo** (33 percent), Romania (30.9 percent) and **Serbia** (35.7 percent) had the lowest ratios. **Montenegro** (55.6 percent) has had a relatively high ratio, but this has declined over the years. **Bosnia** experienced a sharp drop in 2008 and then rebounded in 2009, partly due to increased deposit insurance coverage. **Macedonia** has been fairly stable in the 44-46 percent range in 2007-09.

- *EURASIA*: Deposit mobilization has been lower in this region relative to GDP, with several countries (**Armenia, Azerbaijan, Georgia**) below 20 percent and **Belarus** (21.8 percent) barely above this level. **Moldova** (38.9 percent), Russia (34.6 percent) and **Ukraine** (37.4 percent) are comparable and closer to the lower end of CEE NORTHERN and SOUTHERN TIER performance. Meanwhile, elsewhere in EURASIA, Central Asia has limited data. Kazakhstan (35.4 percent) and Mongolia (39.4 percent) are similar to the lower end of CEE NORTHERN and SOUTHERN TIER markets, whereas Kyrgyz Republic and Tajikistan are closer to the Caucasus countries where deposit mobilization is the lowest in EURASIA.



5.3. Credit-to-GDP

CEE NORTHERN TIER shows significantly higher credit levels than the other regions, with CEE SOUTHERN TIER lagging CEE NORTHERN TIER, followed by EURASIA. Two of the Baltic states in particular show very high ratios, with Estonia averaging 101.3 percent credit to GDP in 2007-09 and Latvia 98.7 percent. Part of the impact on the ratios in these countries has to do with declining GDP in 2009. However, in general, CEE NORTHERN TIER countries show ratios exceeding 60 percent in most cases, with the Czech Republic, Poland and Slovakia being exceptions. By contrast, apart from Bulgaria and **Montenegro**, both of which were above 70 percent, and **Kosovo** (28.4 percent), CEE SOUTHERN TIER averages were in the 40-60 percent range. EURASIA shows ratios generally in the 20-40 percent range apart from **Ukraine** (75 percent), which has run into very serious problems of non-performing loans. Data for Central Asia were limited to Kazakhstan (2007-09), Mongolia (2007-08) and Tajikistan (2007), where the range was 30-60 percent.

Turkey reported 55.5 percent credit to GDP from 2007-09. Croatia reported 75.3 percent from 2007-09.

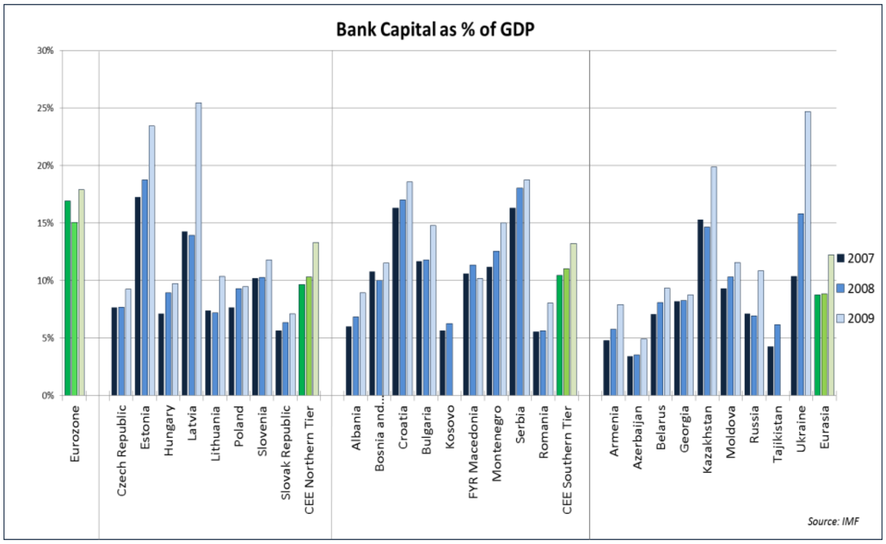
In the Eurozone, credit averaged nearly 140 percent of GDP for 2007-09, well above the CEE and EURASIA regions.

In general, the following trends and observations are made regarding credit to GDP:

- *CEE NORTHERN TIER*: Credit to GDP in the region ranged from 66.2 percent in 2007 to 78.7 percent in 2009. As noted above, this is partly skewed by Estonia and Latvia where GDP declined. However, in general, CEE NORTHERN TIER has provided higher levels of credit than other regions under review. Most of the countries have ratios of about 65 percent of GDP or higher, although the Czech Republic, Poland, and Slovakia have lower ratios.

- *CEE SOUTHERN TIER*: The region shows a range of credit-to-GDP ratios, with **Montenegro** (86 percent) at the high end and **Kosovo** (28 percent) at the low end. Bulgaria (73 percent)was well above the regional average, while **Albania** (60 percent) and **Bosnia** (56 percent) are closer to the average for the region. **Macedonia,** Romania and **Serbia** (42-44 percent) are below the average.

- *EURASIA*: Credit to GDP is lower in this region than in the other regions, with **Ukraine** being the exception (75 percent). As noted above, **Ukraine** has encountered very serious asset quality problems after 2008. As such, its credit allocation has actually declined as GDP has also declined. Apart from **Ukraine**, Russia (44 percent) and **Moldova** (41 percent) have been fairly stable in terms of their credit-to-GDP ratios. **Armenia and Azerbaijan** (both at 20 percent) and Belarus (36 percent) have shown increases year on year from 2007-09, whereas **Georgia** (31 percent) levelled off in 2009. Kazakhstan (59 percent) is similar to some of the better performing CEE SOUTHERN TIER countries, while Mongolia (41.5 percent) is similar to Russia and **Moldova** in EURASIA, and Romania, **Serbia and Macedonia** in the CEE SOUTHERN TIER. Tajikistan reported a 29.4 percent ratio in 2007 which, at the time, was comparable to **Georgia and Belarus**.



5.4. Bank Capital-to-GDP

As for capital as a share of GDP, CEE SOUTHERN TIER had the highest average (about 11.6 percent), slightly higher than CEE NORTHERN TIER (11.1 percent) and higher than EURASIA (about 10 percent). PFS Beneficiary countries in CEE SOUTHERN TIER and EURASIA had bank capital slightly below their respective regional norms.

Turkey reported 12.7 percent capital to GDP from 2007-09. Croatia reported 17.3 percent from 2007-09.

In the Eurozone, capital averaged 16.6 percent of GDP for 2007-09, with an increase in 2009 reflecting the slowdown of GDP growth plus efforts to increase capital in the financial system after decapitalization occurred n 2008.

In general, the following trends and observations are made regarding capital to GDP:

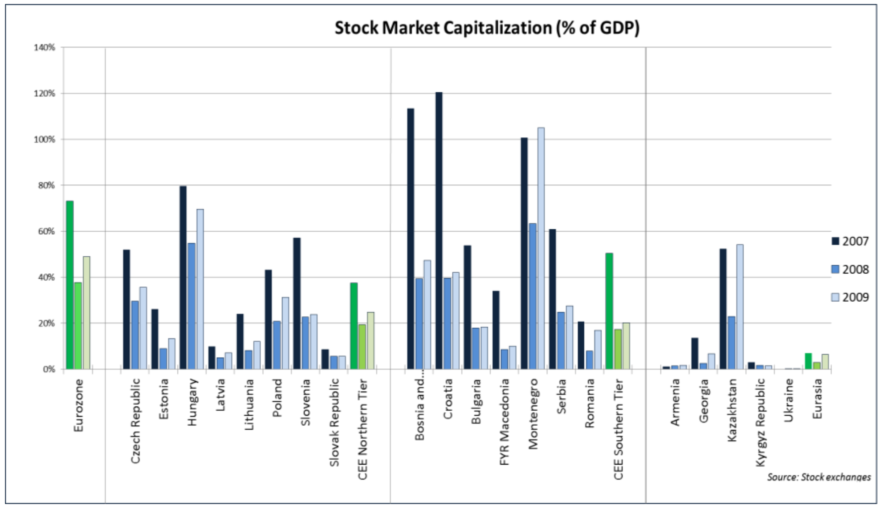
- *CEE NORTHERN TIER*: Capital to GDP in the region ranged from 9.7 percent in 2007 to 13.3 percent in 2009. This is partly skewed by Estonia and Latvia where GDP has declined, resulting in capital ratios in the 23-26 percent of GDP range. All countries in the CEE NORTHERN TIER region have shown increased capital-to-GDP. However, unlike Estonia and Latvia where the ratios increased 6 and 11 percent, respectively, from 2007-09, the other countries have shown more measured increases. By 2009, capital to GDP was less than the regional average in all countries except Estonia (23.4 percent) and Latvia (25.5 percent). The Czech Republic, Hungary, Poland, and Slovakia were in the 8-10 percent range, while Lithuania (10.4 percent) and Slovenia (11.8 percent) were slightly higher, but below the regional average.

- *CEE SOUTHERN TIER*: The region has also shown year-on-year increases in the bank capital-to-GDP, from 10.5 percent in 2007 to 13.2 percent in 2009. The average is partly skewed by **Serbia** (17.7 percent average), although this is offset by **Kosovo's** (6 percent) and Romania's (6.4 percent) low ratios. **Montenegro** (12.9 percent average) was also slightly higher than the regional three-year average, while

Albania (7.3 percent), **Bosnia** (10.8 percent) and **Macedonia** (10.7 percent) were below the regional average. (**Albania's** capital likely needs to increase, particularly in light of its rising NPLs, although capital adequacy measures for **Albania** are strong.) Bulgaria was above the regional average at 12.8 percent.

- *EURASIA*: Capital to GDP is lower in this region than in the other regions, with **Ukraine** being the exception (17 percent). As noted above, **Ukraine** has encountered very serious asset quality problems after 2008, and the drop in 2009 GDP may explain much of the increased capital to GDP ratio, much like Estonia and Latvia in CEE NORTHERN TIER. Apart from **Ukraine**, only **Moldova** has a ratio exceeding 10 percent (10.4 percent), with **Azerbaijan** (4 percent) particularly low. **Georgia** (8.4 percent), Russia (8.3 percent), **Belarus** (8.2 percent) are virtually identical, and **Armenia** is lower at 6.2 percent (all averages for 2007-09). Elsewhere in EURASIA, Kazakhstan averaged 16.6 percent capital to GDP from 2007-09, and it is the only country in the region with data for 2009. Mongolia (6.3 percent) and Tajikistan (5.2 percent) showed far lower ratios for 2007-08, and Turkmenistan and Uzbekistan did not report data. (The Kyrgyz Republic showed nearly 18 percent in 2007, but presented no data thereafter.)

5.5. Stock Market Capitalization-to-GDP

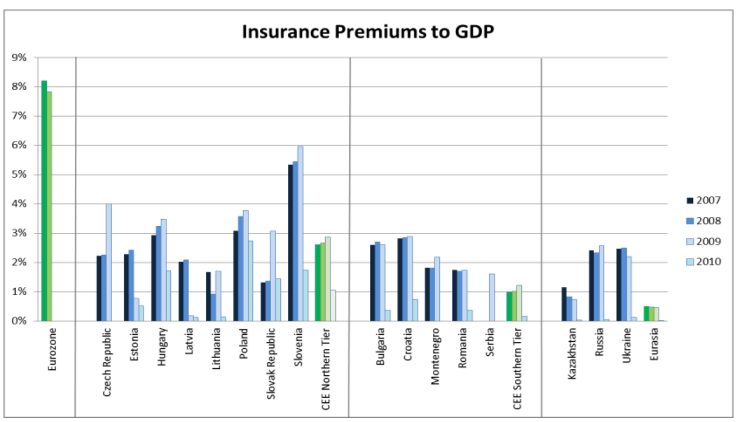


CEE NORTHERN TIER countries have shown development of an equities market in recent decades. Other regions have likewise been able to float securities and achieve respectable stock market capitalization figures, although stock market capitalization values are often subject to debate due to the lack of free float on the exchanges, insider control, questionable levels of disclosure of critical information for outside investors, and financial reporting standards. Much of the development of these markets in the weaker economies was spurred by mass privatization programs in the 1990s.

Given the myriad problems of the markets and general business environment, combined with the small size of many of these markets, stock markets have not taken off in any region. In the CEE SOUTHERN TIER region, **Montenegro** (89.7 percent) and **Bosnia** (66.8 percent) have reasonable ratios, yet little activity. As noted above, there is also a question of how accurate those valuations are due to the limited free float in the market. EURASIA countries show little stock market capitalization[27]. (This is discussed in greater detail below in Sophistication of Financial Services.)

5.6. Gross Insurance Premium Revenues-to-GDP

Insurance markets have shown some growth in the regions under review. For instance, the Czech Republic (39th) , Poland (42nd), Hungary (45th) and Slovakia (46th) all have reasonable levels of insurance market penetration, even in recent years where the regional economy has slowed. Slovenia in particular continues to maintain a fairly high penetration ratio of around 6 percent (2009), placing it 25th in the world. In CEE SOUTHERN TIER, there are four countries with reasonable penetration rates: Croatia (49th), Bulgaria (53rd), **Serbia** (64th), and Romania (65th). In EURASIA, Russia (54th), **Ukraine** (60th) and Kazakhstan (85th) also have emerging insurance markets. However, in general, PFS Beneficiary countries (with two exceptions) are no higher than 89th in the world in their insurance premiums to GDP ratios, reflecting ratios of less than 0.5 percent of GDP.



[27] Kazakhstan (43.2 percent) has had a functioning exchange for years. However, other countries of the region show little to no value in terms of stock market capitalization to GDP. Surprisingly, this includes Russia, which has had no more than 3-4 percent market capitalization to GDP in recent years.

Gross insurance premiums approximate 1.9 to 2.6 percent of GDP in the three regions under review[28]. Apart from Slovenia (6 percent in 2009), Poland (3.8 percent in 2009) and Hungary (3.5 percent), all countries for which data are available showed ratios no higher than 2.9 percent (Croatia). Countries for which data are not available are assumed to have ratios below 0.5 percent.

On a regional basis, CEE NORTHERN TIER showed 2.9 percent in 2009, followed by CEE SOUTHERN TIER (2.2 percent) and EURASIA (1.8 percent). The last two regions experienced slight declines in 2008-09, and CEE NORTHERN TIER has stagnated. These trends reflect the economic slowdown in the regions, particularly as most of these markets are predominantly non-life and both households and businesses cut back on policies during times of economic hardship.

The 2009 premium revenues in the regions compare with Turkey (1.3 percent), Croatia (2.9 percent) and the Eurozone (3.5 percent in 2008). Thus, some of the countries have greater insurance penetration than Turkey, but lag Croatia and the developed Eurozone market.

[28] Data for non-life insurance and, therefore, gross insurance premium revenues were only available for 16 countries. Therefore, including data from the other 15 countries across the regions would bring down the averages.

6. Sophistication of Financial Services

Apart from banking, most CEE SOUTHERN TIER and EURASIA markets have shown limited financial sector development. There are some exceptions in the securities markets, as a handful of countries have shown reasonable levels of stock market capitalization and turnover, albeit less so after 2007. CEE NORTHERN TIER is the only region where the non-bank financial sector has shown initial stages of progress in building diversified financial services. However, even here, there has been limited development to date in the capital markets and insurance market. In general, when evaluating bond trading volume, stock market capitalization, and stock market trading volume, the data reflect a general lack of development in the securities markets.

The insurance market has shown some growth in some of the regions under review. However, PFS Beneficiary countries have shown negligible development of insurance markets apart from **Serbia** and **Ukraine**.

- *Bond Market Trading Volume*: Some CEE NORTHERN TIER countries have shown development of a basic bond market in recent decades, with the Czech Republic and Slovakia reporting the highest proportion of bond trading volume as a share of GDP. Surprisingly, **Belarus** has the highest ratio among countries under review. By contrast, most other markets show little if any activity. CEE SOUTHERN TIER has virtually no bond market activity. Apart from **Belarus**, EURASIA shows limited activity, although Russia and Kazakhstan have markets that have operated for years.

> ***Apart from banking, most CEE SOUTHERN TIER and EURASIA markets have shown limited financial sector development. CEE NORTHERN TIER is the only region where the non-bank financial sector has shown initial stages of progress in building diversified financial services. However, even here, there has been limited development to date in the capital markets and insurance market.***

- *Stock Market Capitalization*: CEE NORTHERN TIER countries have shown development of an equities market in recent decades. Other regions have likewise been able to float securities and achieve respectable stock market capitalization figures, although stock market capitalization values are often subject to debate due to the lack of free float on the exchanges, insider control, questionable levels of disclosure of critical information for outside investors, and financial reporting standards. Much of the development of these markets in the weaker economies was spurred by mass privatization programs in the 1990s. Given the myriad problems of the markets and general business environment, combined with the small size of many of these markets, stock markets have not taken off in any region. In the CEE SOUTHERN TIER region, **Montenegro** (89.7 percent) and **Bosnia** (66.8 percent) have reasonable ratios, yet little activity. EURASIA countries show little stock market capitalization, with Kazakhstan being the only exception.

- *Stock Market Trading Volume*: Stock market activity is generally greater in CEE NORTHERN TIER countries than the other regions, with Hungary, the Czech Republic and Poland being the most active markets. By contrast, CEE SOUTHERN TIER has had virtually no stock market activity since 2008, and only modest trading beforehand. EURASIA also shows limited activity.

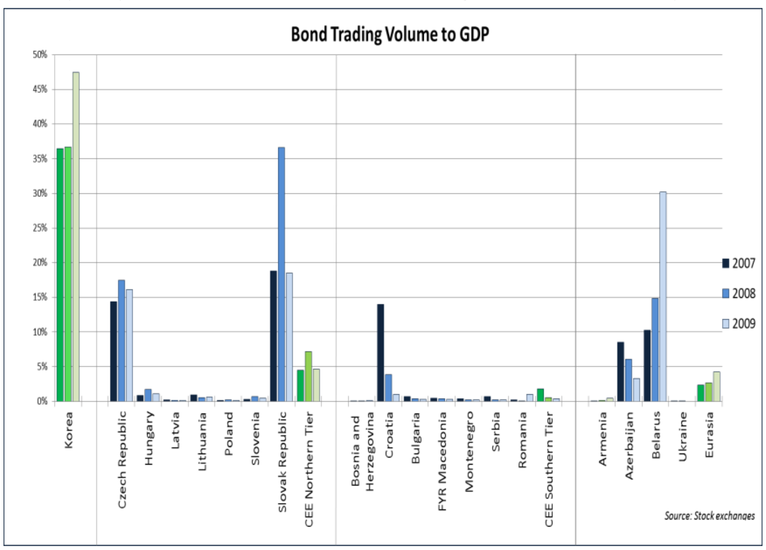
- *Life and Non-Life Insurance Premiums*: The data for the countries under review indicate that life insurance is in its embryonic stages, with only five countries showing life insurance premiums in the 1-2 percent of GDP range: Czech Republic, Hungary, Poland, Slovakia and Slovenia. Thus, CEE SOUTHERN TIER and EURASIA have virtually no life insurance market, while CEE NORTHERN TIER is showing the beginning of a market in several of the countries. In the non-life sector, there has been some development in some of the CEE NORTHERN TIER countries, and these countries have generally shown balanced growth in life and non-life sectors. By contrast, countries in CEE SOUTHERN TIER and EURASIA that have achieved basic levels of insurance market penetration (about 2 percent or above in 2009) are showing most of that growth to be in the non-life sector. Among PFS Beneficiary countries, the two with the highest ratios are **Ukraine** and **Serbia**.

- *Perceptions of Financial Market Sophistication*: The World Economic Forum (WEF) has an index that reflects opinions from surveys on financial market sophistication in various countries. Results in 2009 showed that CEE NORTHERN TIER was the most sophisticated of the three regions with a score of 4.6. CEE SOUTHERN TIER and EURASIA had virtually the same score (3.4). PFS Beneficiary countries in EURASIA were slightly higher (3.6) and showing improvement each year, whereas PFS Beneficiary countries in CEE SOUTHERN TIER were just below the average for the region. These compare with Turkey (5.0), Croatia (4.1) and the Eurozone (5.5).

6.1. Bond Market Trading Volume

Some CEE NORTHERN TIER countries have shown development of a basic bond market in recent decades, with the Czech Republic and Slovakia reporting the highest proportion of bond trading volume as a share of GDP. Surprisingly, **Belarus** has the highest ratio among countries under review. By contrast, most other markets show little if any activity. CEE SOUTHERN TIER has virtually no bond market activity. Apart from **Belarus**, EURASIA shows limited activity, although Russia and Kazakhstan have markets that have operated for years.

Turkey reported bond market trading volume of 65 percent to GDP from 2007-09, much higher than all countries under review. Croatia reported 6.3 percent from 2007-09, with continuous declines after 2007 in response to the economic crisis.



In Korea, bond trading volume averaged 40 percent of GDP in 2007-09, less than Turkey but higher than the countries under review. Korea's trade volume peaked in 2009 at 47.5 percent.

In general, the following trends and observations are made for bond trading volume to GDP:

- *CEE NORTHERN TIER*: The Czech Republic (16 percent) and Slovakia (nearly 25 percent) have active markets. Other countries in the region (Hungary, Poland) show trading volume to be 1 percent or less of GDP.

- *CEE SOUTHERN TIER*: The region shows virtually no bond market trading. Over the 2007-09 period, only **Serbia** approached 1 percent of GDP turnover, and that was in 2007 before the global financial crisis. Bulgaria and Romania both showed little bond market activity at less than 0.5 percent of GDP during the 2007-09 period.

- *EURASIA*: **Belarus** has shown growth in recent years, with bond trading volume approximating 18.5 percent of GDP from 2007-09. However, this ratio is partly inflated due to the decline in GDP in 2009. **Azerbaijan** has also shown signs of a fledgling market, averaging 6 percent turnover during the 2007-09 period. In Central Asia, Kazakhstan is the only bond market that has shown activity for a sustained period. Mongolia showed nearly 1 percent of GDP turnover in 2007, but little activity since.

6.2. Stock Market Capitalization

As with the bond market, CEE NORTHERN TIER countries have shown development of an equities market in recent decades. Other regions have likewise been able to float securities and achieve respectable stock market capitalization figures, although, as noted above, stock market capitalization values are often subject to debate about their accuracy.

Given the myriad problems of the markets and general business environment, combined with the small size of many of these markets, stock markets have not taken off in any region. In the CEE SOUTHERN TIER region, **Montenegro** (89.7 percent) and **Bosnia** (66.8 percent) have reasonable ratios, yet little activity. EURASIA countries show little stock market capitalization, with Kazakhstan (43.2 percent) being the exception.

Turkey reported stock market capitalization of 32.9 percent of GDP from 2007-09. Croatia reported 67.5 percent from 2007-09, although much less in 2008-09 in response to the global economic crisis.

In the Eurozone, stock market capitalization averaged 53.4 percent in 2007-09, peaking in 2007 at 73.1 percent. As a result of the crisis, these values were cut in half in 2008, and then showed a rebound to 49 percent in 2009. However, 2009 values were only about two thirds of 2007 values, reflecting significant net losses in value and the potential volatility associated with capital markets, even in the more advanced economies.

In general, the following trends and observations are made for stock market capitalization to GDP:

- *CEE NORTHERN TIER*: The average stock market capitalization is 27.3 percent in the region from 2007-09. Hungary (68 percent) had the highest average, whereas other countries were in the 30-40 percent range (Czech Republic, Poland, Slovenia). However, the other countries (Estonia, Latvia, Lithuania, Slovakia) had low capitalization figures, at 16 percent of GDP or less.

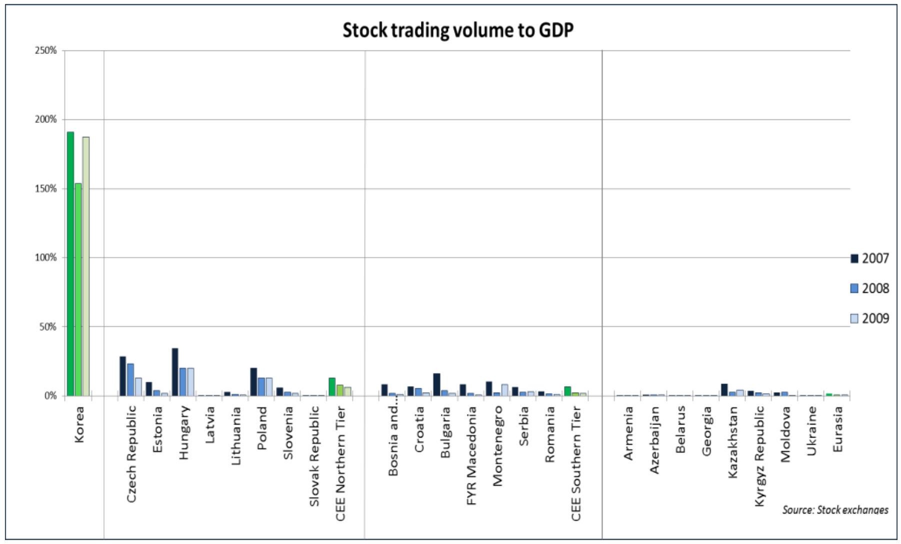
- *CEE SOUTHERN TIER*: The region shows some limited stock market capitalization, although many of the ratios are considered overvalued. **Montenegro** (89.7 percent), **Bosnia** (66.8 percent) and **Serbia** (37.9 percent) have the highest ratios, whereas **Macedonia** (17.6 percent) is lower. **Albania** has no stock market activity, nor does **Kosovo**. Bulgaria averaged 30 percent stock market capitalization from 2007-09, although this dropped to about 18 percent in 2008-09. Romania's stock market capitalization was 15.2 percent in 2007-09, having dropped to 8 percent in 2008 and then rebounded to 17 percent in 2009.

- *EURASIA*: The region shows virtually no stock market capitalization[29]. Kazakhstan is the exception, with an average ratio of 43.2 percent of GDP from 2007-09. **Georgia** had nearly 8 percent value on average

[29] Surprisingly, Russian stock market capitalization-to-GDP was 2.1 percent in 2009. Stock market capitalization fell more than 42 percent from 2007 to 2009 in Russia. Meanwhile, value is heavily weighted towards Gazprom and a few other large stocks, mainly resource-based.

for 2007-09 in its small market, and **Armenia** was below 2 percent. In addition to Kazakhstan in Central Asia, Mongolia averaged nearly 12 percent, and the Kyrgyz Republic averaged 2 percent.

6.3. Stock Market Trading Volume



Stock market activity is generally greater in CEE NORTHERN TIER countries than the other regions, with Hungary, the Czech Republic and Poland being the most active markets. By contrast, CEE SOUTHERN TIER has had virtually no stock market activity since 2008, and only modest trading beforehand. EURASIA also shows limited activity.

Turkey reported stock market trading volume of 43.3 percent to GDP from 2007-09. Croatia reported 4.8 percent from 2007-09, which is higher than most CEE SOUTHERN TIER markets and mid-way between Bulgaria and Romania (both EU members).

In Korea, markets are very liquid, as reflected in turnover ratios averaging 177.4 percent for 2007-09.

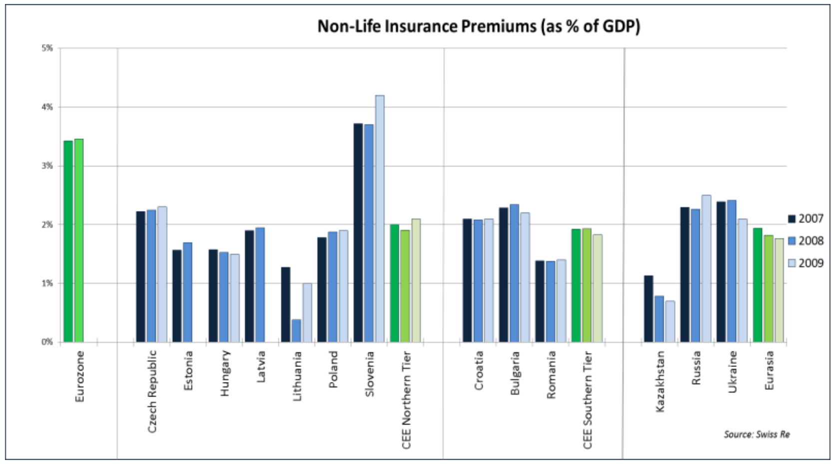
In general, the following trends and observations are made for stock market trading volume to GDP:

- *CEE NORTHERN TIER*: The Czech Republic, Hungary and Poland have stock market trading in the range of 16-25 percent of GDP. Apart from these three countries, the other five markets in the region have limited (Slovakia, Slovenia) or no (Baltic states) reported activity.

- *CEE SOUTHERN TIER*: The region showed some stock market trading in 2007 (7.5 percent of GDP), but this has dropped off since 2008 in response to the economic crisis. **Montenegro** (6.9 percent) has the highest ratio among PFS Beneficiary countries in the region, while **Bosnia** (3.7 percent), **Macedonia** (3.6 percent) and **Serbia** (4 percent) are all comparable. Neither **Albania nor Kosovo** have stock markets. Bulgaria (7.4 percent) showed some activity in 2007, but has dropped off considerably since 2008. Romania has even less activity, averaging less than 2 percent for the 2007-09 period.

- *EURASIA*: The region's stock exchanges are generally inactive apart from Kazakhstan. The PFS Beneficiary countries generally show stock market trading volume to be 2 percent or less of GDP. Central Asian exchanges have shown declining activity after 2007 in the markets for which there are data. Some of the countries (Tajikistan, Turkmenistan, Uzbekistan) lack an active stock exchange, whereas the others are comparatively small apart from Kazakhstan.

6.4. Life Insurance Premium Revenues

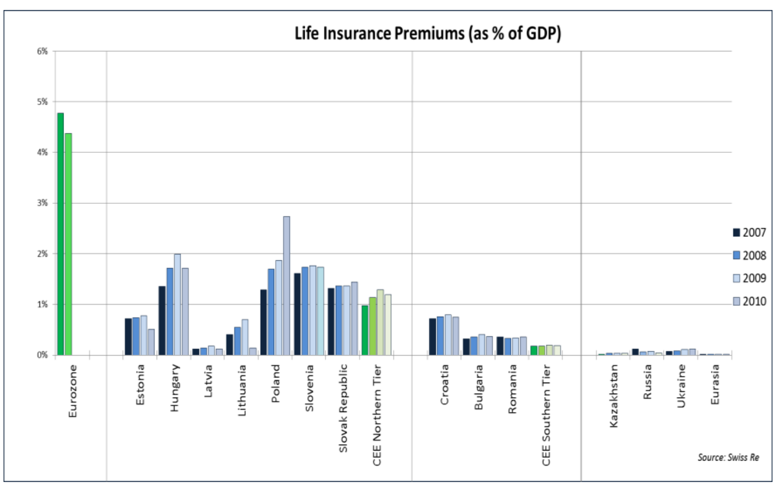


Life insurance premiums reflect the buoyancy of a segment of the financial services industry that provides instruments for retirement savings and protection against catastrophic events, and serves as an institutional catalyst for capital markets development due to the need for long-term financial assets to match long-term liabilities. The data for the countries under review indicate that life insurance is in its embryonic stages, with only five countries showing life insurance premiums in the 1-2 percent of GDP range: Czech Republic, Hungary, Poland, Slovakia and Slovenia. Thus, CEE SOUTHERN TIER and EURASIA have virtually no life insurance market, while CEE NORTHERN TIER is showing the beginning of a market in several of the countries.

Turkey reported life insurance premiums of only 0.2 percent of GDP from 2007-09, while Croatia reported 0.8 percent.

In the Eurozone countries, life insurance premiums averaged 4.6 percent of GDP in 2007-08, reflecting a strong market. The Netherlands, UK and France are 2nd, 3rd and 7th in the world in total insurance premium penetration, respectively, with life insurance being particularly prominent in the UK[30] and France.

6.5. Non-Life Insurance Premium Revenues



Just as life insurance premiums are limited in the countries under review, including the PFS Beneficiary countries, the non-life sector is also relatively small in most countries. There has been some development in some of the CEE NORTHERN TIER countries, and these countries have generally shown balanced growth in life and non-life sectors. By contrast, countries in CEE SOUTHERN TIER and EURASIA that have achieved basic levels of insurance market penetration (about 2 percent or above in 2009) are showing most of that growth to be in the non-life sector. This varies across countries, but often involves transport (e.g., mandatory automobile insurance, commercial vehicle, maritime) along with property insurance (e.g., residential, commercial, warehousing) to protect against hazard and other risks.

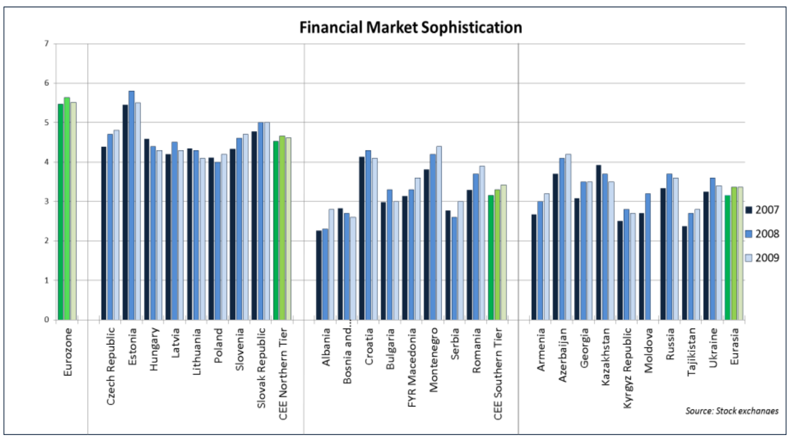
30 Apart from Taiwan (13.8 percent), the UK has the highest level of life insurance penetration in the world (along with South Africa) at 10 percent of GDP.

Among the CEE SOUTHERN TIER and EURASIA countries ranked in the top 89 insurance markets, non-life premium revenues to GDP ranged from 1.4 percent (Romania) to 2.5 percent (Russia), with Croatia (2.1 percent), Bulgaria (2.2 percent), **Ukraine** (2.1 percent) and **Serbia** (1.6 percent) in between.

These 2009 figures compare with Turkey (1.1 percent) and the Eurozone (3.4 percent in 2007-08).

6.6. Financial Market Sophistication Index

The WEF has an index that reflects opinions from surveys on financial market sophistication in various countries. Based on a scale of 2 to 7, the results in 2009 showed that CEE NORTHERN TIER was the most sophisticated of the three regions with a score of 4.6. CEE SOUTHERN TIER and EURASIA had virtually the same score (3.4). PFS Beneficiary countries in EURASIA were slightly higher (3.6) and showing improvement each year, whereas PFS Beneficiary countries in CEE SOUTHERN TIER were just below the average for the region. These compare with Turkey (5.0), Croatia (4.1) and the Eurozone (5.5). Country profiles are as follows:



- Estonia, Slovakia and Turkey were 5.0 or above.
- **Azerbaijan**, Croatia, Czech Republic, Hungary, Latvia, Lithuania, **Montenegro**, Poland and Slovenia were 4.0 or above, but below 5.0.
- **Armenia**, Bulgaria, **Macedonia, Georgia**, Kazakhstan, Romania, Russia, **Serbia** and **Ukraine** were 3.0 or above, but below 4.0.
- **Albania, Bosnia**, Kyrgyz Republic, Mongolia and Tajikistan were 2.0 or above, but below 3.0.

As these are perceptions, there is no assurance that these scores are an accurate reflection of financial market sophistication in these countries. Nonetheless, they reflect the views of those surveyed.

7. Access to Financial Services

Access to financial services has shown variable patterns across regions based on interest rates (affordability), credit availability, and the availability and proximity of infrastructure (e.g., bank branches, ATMs). Rate patterns have differed across regions, as has the response to the economic slowdown. In some countries, the economy was overheated before the crisis and needed a correction. In other cases, interest rates have come down in real terms, even if credit conditions have tightened. As for infrastructure, several countries have invested in branches and ATMs, although most financial services tend to be concentrated in the largest population centers, for obvious reasons, without high levels of innovation or risk-taking being evident in other areas.

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- *Nominal Interest Rate Spreads*: Nominal interest rate spreads have shown a tendency to increase in recent years, largely in response to high inflation rates, overheated economies, and unsustainable current account deficits in the 2007-08 period. Only CEE SOUTHERN TIER has seen a gradual decline in nominal interest rate spreads, whereas the other regions have experienced increases. The CEE SOUTHERN TIER has actually been relatively stable in terms of nominal interest rate spreads, with the average for the region dropping by 47 basis points from 2007-09. PFS country trends in the region have mirrored these movements and been virtually the same as the region as a whole. By contrast, CEE NORTHERN TIER has experienced an increase in average rates of 186 basis points during the period, although average rates have been significantly lower than the other regions. EURASIA has likewise seen an increase in nominal rate spreads of 122 basis points, although the PFS Beneficiary countries of the region have lower rates than non-PFS markets in EURASIA.

- *Real Interest Rate Spreads*: Real interest rate spreads have shown that rates may have been artificially low in 2007-08 in many countries and all regions (with the exception of CEE SOUTHERN TIER in 2007), while correcting in 2009. CEE NORTHERN TIER and EURASIA both show negative real interest rate spreads on average for 2007-09, while CEE SOUTHERN TIER was marginally positive. All regions were positive in 2009, but all were negative in 2008 and 2007 with the sole exception of CEE SOUTHERN TIER in 2007.

- *Borrower Density*: Data on borrower density, as measured by the number of borrowers from commercial banks per 1,000 adults, remains sketchy. However, based on the data available, CEE NORTHERN TIER had about 442 borrowers per 1,000 adults in 2009, while CEE SOUTHERN TIER (155) and EURASIA (136) were similar.

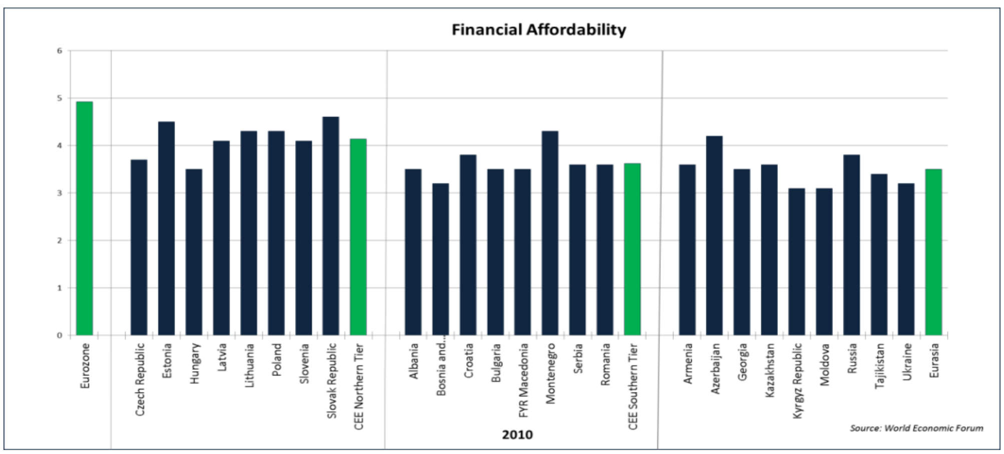
- *Branch Density*: Data are more available on branch density (than borrower density), as measured by the number of commercial bank branches per 1,000 km2. In many countries, the result is that the capital city is well served along with a handful of other towns, while other smaller settlements and rural areas have less access. The figures for all of EURASIA in particular are low at less than 5 branches per 1,000 km2 (about 6 in PFS EURASIA) due to the size and demographic distribution of many of the countries (e.g., Central Asia, Russia). By contrast, CEE NORTHERN and SOUTHERN TIERs averaged 20-24 branches per 1,000 km2.

- *ATM Density*: ATM density, as measured by the number of ATMs per 1,000 km2, shows less variation in ranges than found in the other density statistics (except for Central Asia). Apart from **Moldova** which had 216 ATMs per 1,000 km2 in 2009, most countries had 20-50. CEE NORTHERN TIER and CEE SOUTHERN TIER averaged 38 in 2009, while EURASIA averaged 32.

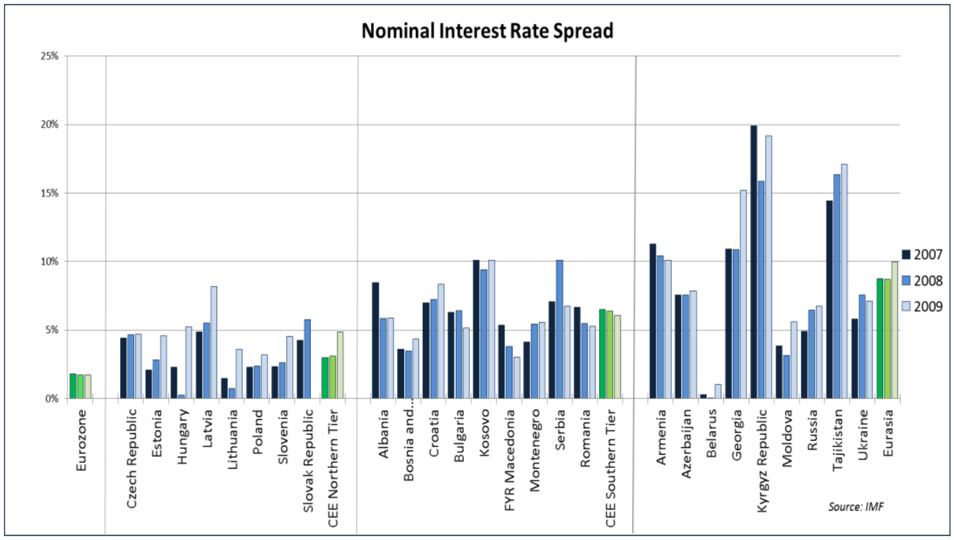
In general, finance is more affordable in the more advanced economies, and these economies also tend to have them most developed infrastructure to help facilitate access. This becomes a virtuous circle as increased access encourages a broadening and deepening of financial services. The following graphic highlights these perceptions based on a survey conducted by the World Economic Forum.

7.1. Nominal Interest Rate Spreads

Nominal interest rate spreads have shown a tendency to increase in recent years, largely in response to high inflation rates, overheated economies, and unsustainable current account deficits in the 2007-08 period. Only CEE SOUTHERN TIER has seen a gradual decline in nominal interest rate spreads, whereas the other regions have experienced increases. The CEE SOUTHERN TIER has actually been relatively stable in terms of nominal interest rate spreads, with the average for the region dropping by 47 basis points from 2007-09. PFS country trends in the region have mirrored these movements and been virtually the same as the region as a whole. By contrast, CEE NORTHERN TIER has experienced an increase in average rates of 186 basis points during the period, although average rates have been significantly lower than the other regions. EURASIA has likewise seen an increase in nominal rate spreads of 122 basis points, although the PFS Beneficiary countries of the region have lower rates than non-PFS markets in EURASIA.



By comparison, Croatia reported 7.5 percent rates on average 2007-09, higher than CEE NORTHERN and SOUTHERN TIER countries, but lower than EURASIA (albeit higher than PFS EURASIA).



In the Eurozone, nominal interest rate spreads have come down a little since 2007, but with surprisingly little change[31]. Nominal interest rate spreads in the Eurozone averaged 1.74 percent in 2007-09, dropping from 1.79 percent in 2007 to 1.70 percent in 2008 and then up again to 1.73 percent in 2009.

In general, the following trends and observations are made for nominal interest rate spreads:

- *CEE NORTHERN TIER*: The region had relatively low (3.6 percent) average interest rate spreads, the lowest of the three regions. These rates have been particularly low on average in Estonia and Slovenia (3.2 percent), Hungary (2.6 percent) and Lithuania (1.9 percent).

- *CEE SOUTHERN TIER*: The region averaged 6.3 percent nominal interest rate spreads, and has seen those rates come down year on year since the crisis. Aside from 2008 when inflation rates jumped up, the inflation rate has declined since 2009. Thus, the region has been able to benefit from lower nominal interest rate spreads, particularly in **Bosnia** (3.8 percent), **Macedonia** (4.1 percent) and **Montenegro** (5.0 percent). By contrast, **Albania** (6.7 percent), **Kosovo** (9.9 percent) and **Serbia** (8.0 percent) have been above the regional average. Bulgaria (6 percent) and Romania (5.8 percent) have been slightly lower than the regional average.

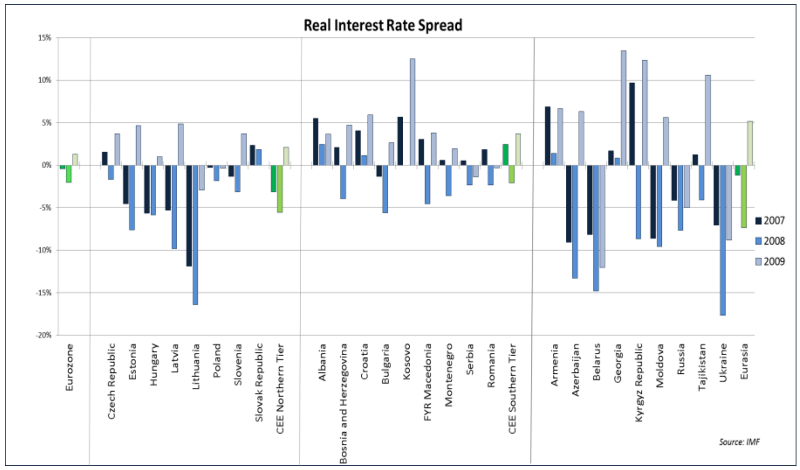
- *EURASIA*: The region's nominal interest rate spreads were more than 8.7 percent in 2007-08 and then jumped to 10 percent in 2009, for an average of 9.1 percent. However, there has been considerable variation at the national level, and PFS Beneficiary countries in the region have generally had lower nominal interest rate spreads than non-PFS Beneficiary countries. **Georgia** (12.3 percent) and **Armenia** (10.6 percent) were among the highest on average for all countries under review, while **Belarus** (0.4 percent) was the lowest for all countries. **Moldova** (4.2 percent), Russia (6.0 percent) and **Ukraine** (6.8 percent) have been below the average, including the 7 percent PFS EURASIA average, whereas **Azerbaijan** (7.7 percent) has been above. However, apart from **Georgia and Armenia**, the other PFS Beneficiary countries have been below the EURASIA average. By contrast, Central Asian nominal interest rate spreads have been the highest of all at more than double PFS EURASIA rates at 14.3 percent on average. However, the data are limited to three countries, and thus may be skewed. The

[31] Fiscal deficits rather than monetary policy have been the tools that countries have used to create stimulus to offset the economic slowdown. However, net spreads have declined in real terms, so fiscal tools have been accompanied by some real easing of interest rates.

Kyrgyz Republic (18.3 percent) and Tajikistan (16.0 percent) are the highest of all countries under review, while Mongolia's rates were 8.6 percent on average.

7.2. Real Interest Rate Spreads

Real interest rate spreads have shown that rates may have been artificially low in 2007-08 in many countries and all regions (with the exception of CEE SOUTHERN TIER in 2007), while correcting in 2009. CEE NORTHERN TIER and EURASIA both show negative real interest rate spreads on average for 2007-09, while CEE SOUTHERN TIER was marginally positive. All regions were positive in 2009, but all were negative in 2008 and 2007 with the sole exception of CEE SOUTHERN TIER in 2007.



Croatia reported 3.7 percent rates on average 2007-09.

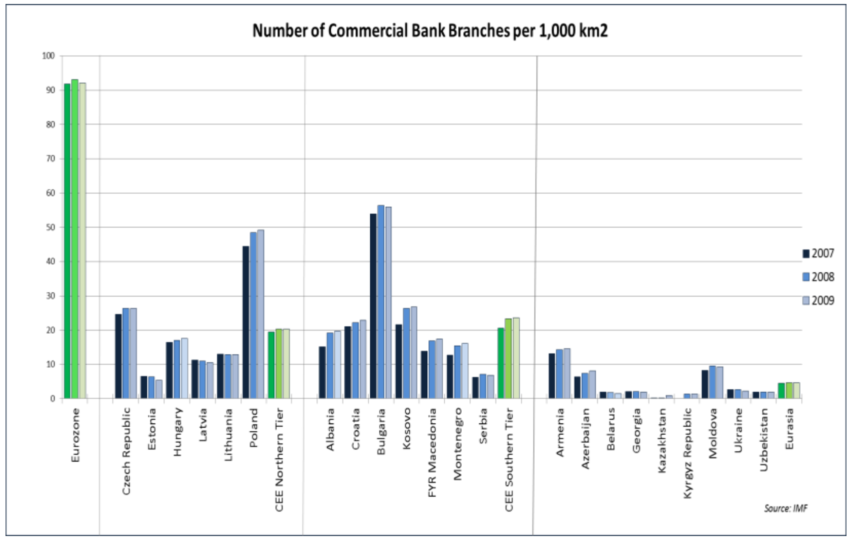
In the Eurozone, real interest rate spreads went negative in 2007-08 to help stimulate the economy. They have since returned to positive net spreads of 1.3 percent in 2009 after averaging a negative 1.2 percent in 2007-08.

In general, the following trends and observations are made for real interest rate spreads:

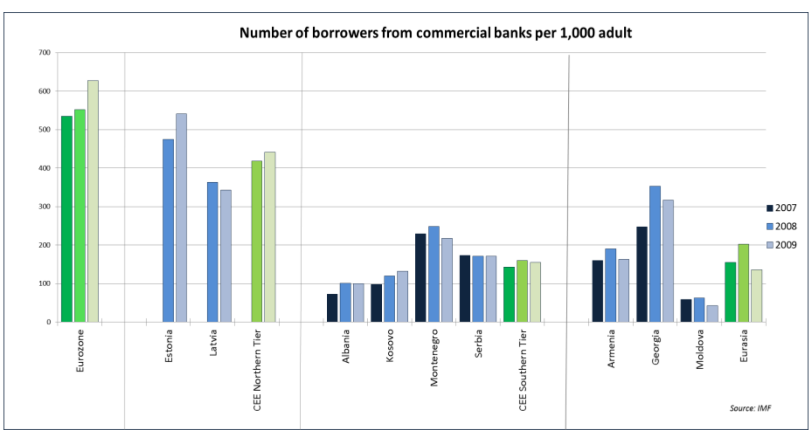
- *CEE NORTHERN TIER*: The region had negative 2.2 average real interest rate spreads, although they turned very positive in 2009 with the steep decline in inflation rates. Rates were particularly negative Estonia, Hungary, Latvia and Lithuania where significant problems have materialized in the financial sector. Slovenia and Poland were also negative for the period, but less so than the other four countries cited above. The Czech Republic and Slovakia were the only countries in the region with positive real net spreads.

- *CEE SOUTHERN TIER*: The region averaged positive 1.4 percent real interest rate spreads, and rates have been less volatile in CEE SOUTHERN TIER than in the other regions. **Kosovo** had 6.1 percent real interest rate spreads, by far the highest in the region and higher than all countries under review. **Albania** was also strongly positive at 3.9 percent. Other countries were marginally positive (**Bosnia, Macedonia**) or marginally negative (**Montenegro, Serbia**).

- *EURASIA*: The region's real interest rate spreads were negative 2.3 percent for 2007-09, and have shown significant volatility, in many ways consistent with the swings in inflation rates. The region kept nominal rates flat in 2007-08, yet inflation rates increased from 10.5 percent to 16.3 percent (slightly lower among PFS Beneficiary countries in 2008). This resulted in a real interest rate spread decline from negative 1.9 percent in 2007 to negative 8.2 percent in 2008, with PFS Beneficiary countries experiencing negative 4.0 percent in 2007 and negative 8.8 percent in 2008. Real interest rates then turned positive (3.3 percent in EURASIA, and 1.9 percent among PFS Beneficiary countries) in 2009 as inflation rates declined to 6.6 percent in the region (5.9 percent in PFS Beneficiary countries). As with nominal interest rate patterns, there has been considerable variation at the national level with real interest rate spreads. However, the extremes have been reversed in the sense that countries with the highest nominal rates have had positive real interest rates, and those with low nominal rates have had the most negative real interest rates. Thus, **Georgia** (5.3 percent) and **Armenia** (5.0 percent) had positive rates, in contrast to **Belarus**, which had deeply negative (11.64 percent) spreads. **Azerbaijan** (negative 5.3 percent), **Moldova** (negative 4.2 percent), Russia (negative 5.6 percent) and **Ukraine** (negative 11.2 percent) were also all negative, with **Ukraine** in particular facing severe financial sector challenges. Similar patterns of volatility were also found in the Kyrgyz Republic, Tajikistan and Mongolia.



7.3. Borrower Density



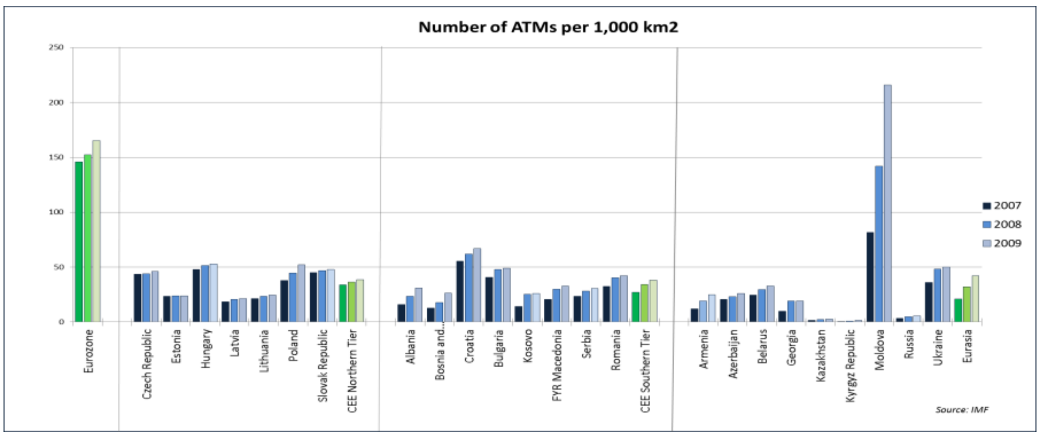
Data on borrower density, as measured by the number of borrowers from commercial banks per 1,000 adults, remains sketchy. However, based on the data available, Turkey has the most borrowers (732 in 2009), followed by Mongolia (720), Estonia (541), Latvia (343) and **Georgia** (317). Other countries in the 100-300 range included **Albania, Armenia, Montenegro and Serbia**. The Kyrgyz Republic and **Moldova** were less than 100. Mongolia has shown particular growth since 2008, whereas **Armenia, Georgia**, Latvia, **Moldova and Montenegro** showed declines in 2009. In the latter case, this serves as an indicator of a tightened credit market.

In general, CEE NORTHERN TIER had about 442 borrowers per 1,000 adults in 2009, while CEE SOUTHERN TIER (155) and EURASIA (136) were similar. (Central Asia reported higher figures, but this was skewed by Mongolia, only one of two countries from the region for which data are available.)

7.4. Branch Density

Data are more available on branch density (than borrower density), as measured by the number of commercial bank branches per 1,000 km2. Based on the data available for 2009, Bulgaria (56) and Poland (49) have the highest branch density. Those in the 10-25 branch range include **Albania** (20), **Armenia** (15), Croatia (23), Czech Republic (26), **Macedonia** (18), Hungary (18), Latvia (11), Lithuania (13), **Montenegro** (16) and Turkey (12). Countries with fewer branches included **Azerbaijan, Belarus**, Estonia, **Georgia**, Kazakhstan, Kyrgyz Republic, **Moldova**, Mongolia, **Serbia, Ukraine** and Uzbekistan.

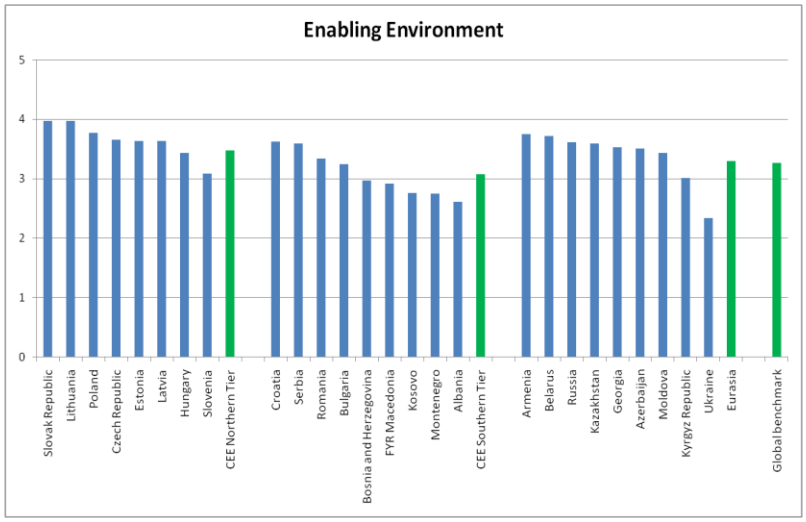
At a minimum, the data need to account for land mass and population distribution. In countries with only a handful of cities and vast expanses of land, density levels for the country are likely to be low even though most people may be well served. However, in many countries, the result is that the capital city is well served along with a handful of other towns, while other smaller settlements and rural areas have less access. The figures for all of EURASIA in particular are low at less than 5 branches per 1,000 km2 (about 6 in PFS EURASIA) due to the size and demographic distribution of many of the countries (e.g., Central Asia, Russia). By contrast, CEE NORTHERN and SOUTHERN TIERs averaged 20-24 branches per 1,000 km2.



7.5. ATM Density

ATM density, as measured by the number of ATMs per 1,000 km2, shows less variation in ranges than found in the other density statistics (except for Central Asia). Apart from **Moldova** which had 216 ATMs per 1,000 km2 in 2009, most countries had 20-50. Croatia (67), Hungary (53) and Poland (52) were above that range, and Kazakhstan (3), Kyrgyz Republic (2) and Russia (6) were below that range. Otherwise, all the other countries for which data were reported were in the 20-50 range, with CEE NORTHERN TIER and CEE SOUTHERN TIER averaging 38 in 2009.

8. Financial Sector Enabling Environment



The business environment for financial sector development shows improvements are needed in many areas of the financial sector enabling environment, although positive trends since 2007 are also evident. Property registration and contract enforcement are time-consuming, credit information is not always available for loan decision-making, investor protection is weak in many countries, and auditing and accounting standards are also weak in several countries. More positively, there have been improvements reported across the board in many countries, and there seems to be recognition of the need to improve the environment for the financial sector to develop and diversify.

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- *Property Registration*: Property registration procedures are most numerous in CEE SOUTHERN TIER countries (6.7 in 2010), less numerous in EURASIA (5.3, and only 4.3 among PFS EURASIA), and least numerous as a region in CEE NORTHERN TIER (4.3 in 2010). Time required to register property is fairly similar in CEE NORTHERN and SOUTHERN TIER countries (51 and 55 days, respectively, in 2010), which is high when compared to the Eurozone (34 days in 2010). By contrast, EURASIA is similar to the Eurozone in that it requires significantly fewer days (33 in 2010), particularly in the PFS Beneficiary countries (26). As for property registration costs (as measured by the percent of property value per capita), there is regional variation. In 2010, EURASIA had the lowest average costs, at 1.35 percent, and only 0.93 percent for the PFS Beneficiary countries. CEE NORTHERN TIER was also relatively low, with average costs at about 1.86 percent. These costs are higher in CEE SOUTHERN TIER where the average cost was 3.1 percent in 2010.

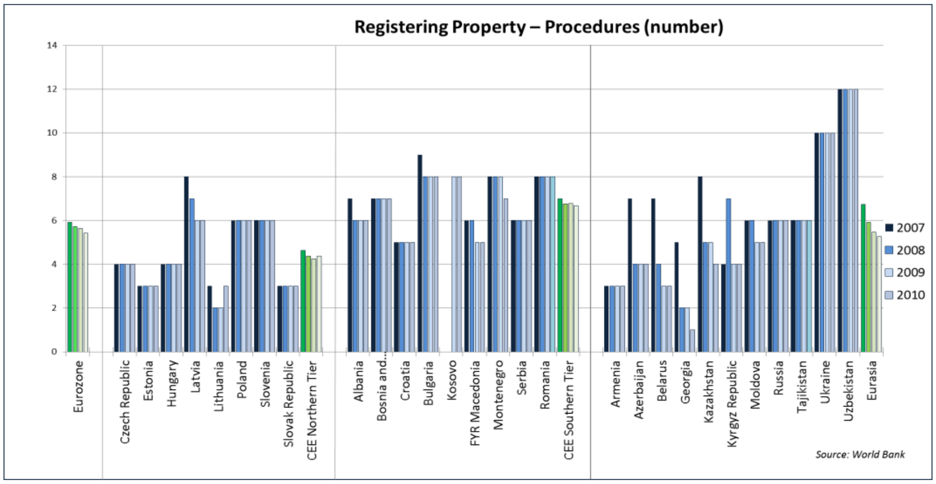
- *Contract Enforcement*: Contract enforcement procedures are most numerous in CEE SOUTHERN TIER countries (40 in 2010; 42 among PFS Beneficiary countries), but not too different in EURASIA (37 in 2010; 36 among PFS EURASIA), and least numerous as a region in CEE NORTHERN TIER (32 in 2010). Time required to enforce contracts is varied, with CEE NORTHERN and SOUTHERN TIER countries (588 and 513 days, respectively, in 2010), which is high when compared to EURASIA (300 days) but fewer than the Eurozone (608 days in 2010). EURASIA showed variation, with **Azerbaijan** (237) and **Belarus** (225) at the low end, **Armenia and Georgia** (285) near the regional average, and **Moldova** (365) and **Ukraine** (345) requiring more time. In the PFS CEE SOUTHERN TIER countries, there was also considerable variation, with **Albania** (390), **Kosovo** (420), **Macedonia** (370) below the regional average, while **Bosnia** (595), **Montenegro** (545) and **Serbia** (635) were above the regional average. As for contract enforcement costs (as measured by the percent of debt expended in loan/debt recovery efforts), there is regional variation. In 2010, CEE NORTHERN TIER had the lowest average costs, at 22 percent in 2010. EURASIA was also relatively low, with average costs at about 24 percent (25.5 percent for the PFS Beneficiary countries). These costs are higher in CEE SOUTHERN TIER where the average cost was 32.5 percent (37.7 percent in PFS Beneficiary countries) in 2010. All of this compares with 18.3 percent in the Eurozone, 18.8 percent in Turkey, and only 13.8 percent in Croatia.

- *Getting Credit*: In general, credit in 2010 appeared to be most accessible in CEE SOUTHERN TIER countries, followed by CEE NORTHERN TIER countries and then EURASIA. Access to relevant credit information on borrowers by lenders is essential in developing the credit market. Thus, public and private credit information services are needed to accommodate credit information needs. When combining coverage ratios between public registries and private credit bureaus, the 2010 figures show the CEE NORTHERN TIER countries (49.8 percent) are virtually identical to the Eurozone (50.2 percent), with the CEE SOUTHERN TIER slightly lower (46.6 percent; PFS at 40.3 percent) and EURASIA the lowest (17.8 percent; PFS at 20.4 percent). Thus, the PFS Beneficiary countries have room to improve their coverage ratios, although they have also shown increases in ratios since 2007. (Turkey had a 60.5 percent ratio in 2010, and Croatia was at 81.2 percent.)

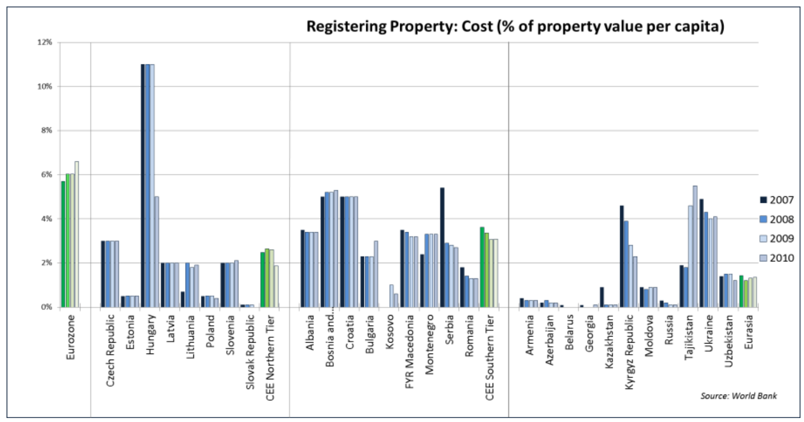
- *Investor Protection*: Investor protection is essential for the volume as well as the value of investment into businesses. Legal and institutional protection that is consistently enforced is needed to offset other market risks that are faced by investors. The weaker the protection, the weaker the likelihood of investment into the country. Measures for success include actions to protect minority shareholder rights against abuses by majority shareholders, including adequate disclosures, protection against insider dealings and transactions, and an effective court system that permits legal challenges when violations have occurred. Rankings of countries and regions on investor protection indicate that legal protections lag Eurozone standards in all three regions. Based on the rankings, the average 2010 ranking for the Eurozone was 84, followed by CEE NORTHERN TIER countries (75), EURASIA (73, with PFS at 77), and then CEE SOUTHERN TIER countries at 69 (PFS at 67).

- *Auditing and Reporting Standards*: Auditing and reporting standards are strongest in CEE NORTHERN TIER, then CEE SOUTHERN TIER, followed by EURASIA. At the high end among all countries under review are Estonia, Hungary, Slovenia, Czech Republic and Lithuania. At the low end are **Azerbaijan**, **Serbia**, Mongolia and Russia, Tajikistan, Kyrgyz Republic, **Ukraine** and **Bosnia**.

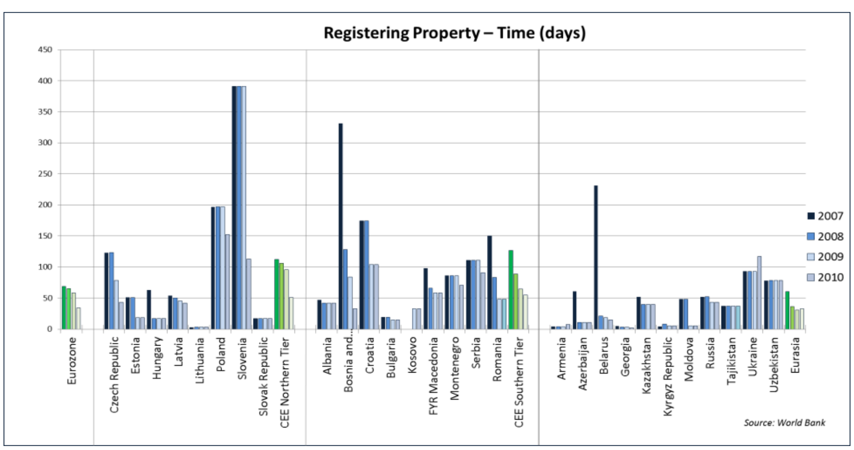
8.1. Property Registration



Easy, fast and cheap property registration is helpful in establishing collateral records that are often needed to arrange for secured loans. Conversely, cumbersome, slow and expensive procedures constrain market development by slowing down transactions and making them more expensive. Therefore, assessing the degree to which property registration practices enable the market involves numbers of procedures, time required, and costs.



Property registration procedures are most numerous in CEE SOUTHERN TIER countries (6.7 in 2010), less numerous in EURASIA (5.3, and only 4.3 among PFS EURASIA), and least numerous as a region in CEE NORTHERN TIER (4.3 in 2010). These figures compare with 6 in Turkey, 5.4 in the Eurozone, and 5 in Croatia. Among PFS Beneficiary countries, EURASIA ranged from a low of 1 in **Georgia** to a high of 10 in **Ukraine**[32], with **Armenia, Azerbaijan, Belarus and Moldova** all in the 3 to 5 range in 2010. As for PFS Beneficiary countries in CEE SOUTHERN TIER, **Macedonia** (5) had the fewest steps while **Kosovo** had the most (8), with **Albania, Bosnia, Montenegro and Serbia** in between.



Time required to register property is fairly similar in CEE NORTHERN and SOUTHERN TIER countries (51 and 55 days, respectively, in 2010), which is high when compared to the Eurozone (34 days in 2010). By contrast, EURASIA is similar to the Eurozone in that it requires significantly fewer days (33 in 2010), particularly in the PFS Beneficiary countries (26). EURASIA is skewed at both ends of the spectrum by **Georgia** (2 days), **Moldova** (6 days) and **Armenia** (7 days) as opposed to **Ukraine** (117 days). **Belarus** (15) and **Azerbaijan** (11) are also reasonably fast when compared with other countries. In the PFS CEE SOUTHERN TIER countries,

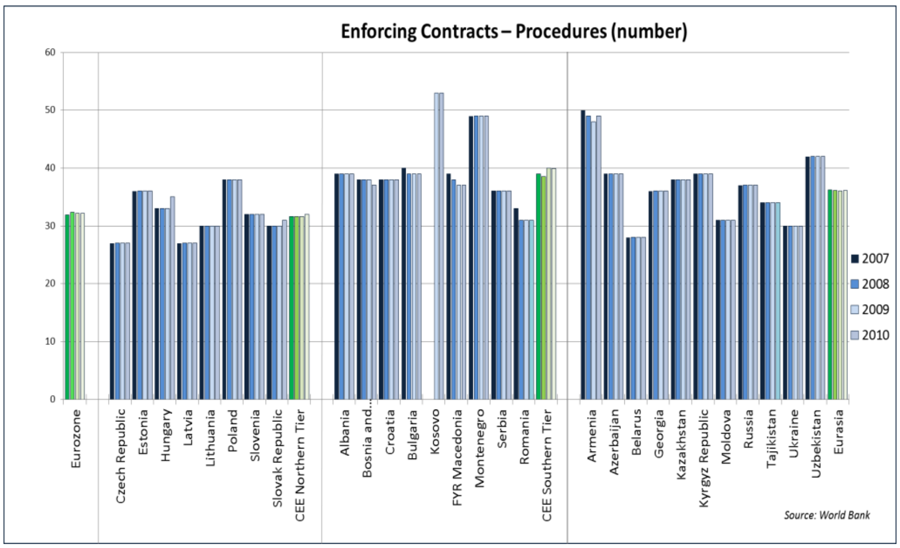
[32] In this case, low is good (i.e., low number of procedures), and high is not.

Bosnia and Kosovo required 33 days in 2010, while **Serbia** required 91. **Albania** (42), **Macedonia** (58) and **Montenegro** (71) were in between.

As for property registration costs (as measured by the percent of property value per capita), there is regional variation. In 2010, EURASIA had the lowest average costs, at 1.35 percent, and only 0.93 percent for the PFS Beneficiary countries. CEE NORTHERN TIER was also relatively low, with average costs at about 1.86 percent. These costs are higher in CEE SOUTHERN TIER where the average cost was 3.1 percent in 2010.

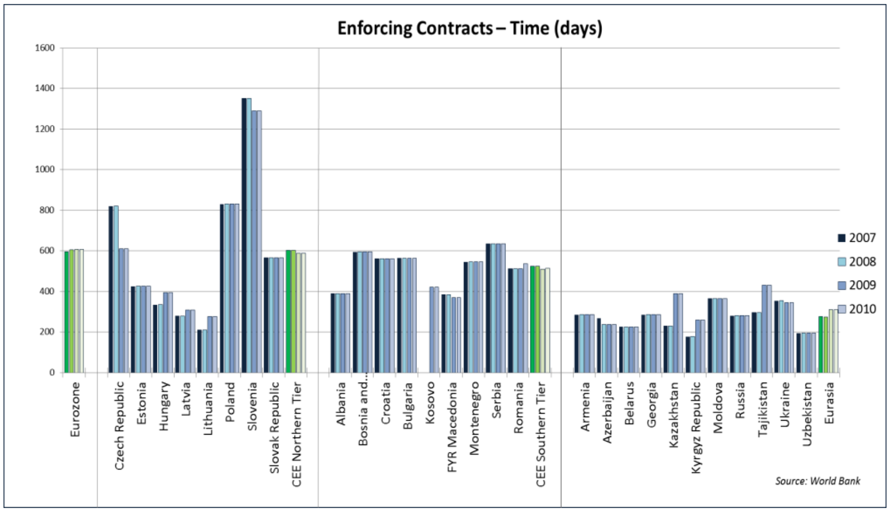
In general, most countries have kept these costs at or below 3 percent on average from 2007-10. Among the PFS Beneficiary countries in CEE SOUTHERN TIER in 2010, **Albania** (3.4 percent), **Bosnia** (5.3 percent), **Macedonia** (3.3 percent), and **Montenegro** (3.1 percent) were above the 3 percent threshold, whereas **Kosovo** (0.6 percent) and **Serbia** (2.7 percent) were below. In EURASIA, all PFS Beneficiary countries were below the 1 percent threshold except **Ukraine**, which had costs of 4.1 percent in 2010.

8.2. Contract Enforcement

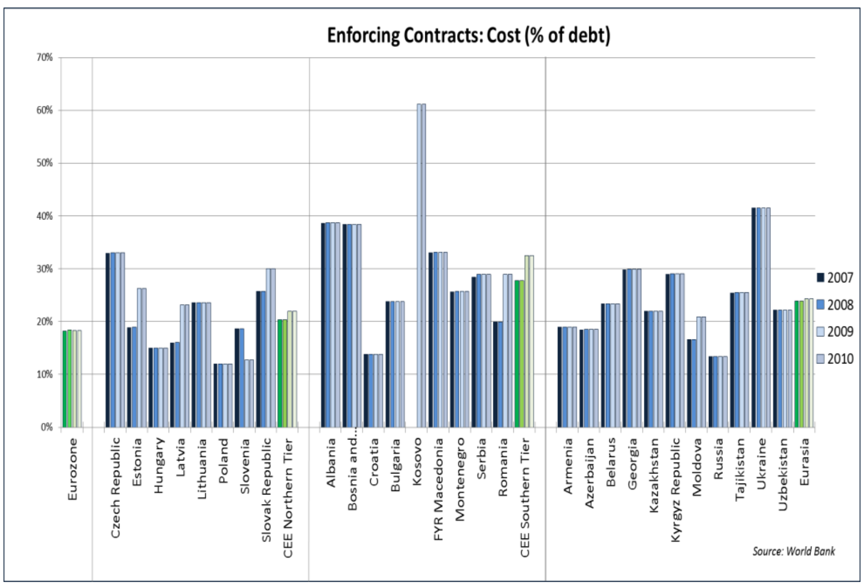


Contract enforcement (including loan/debt recovery) is essential for the protection of both creditor and borrower rights and responsibilities. In many emerging markets, contract enforcement has been undermined by ineffective court processes, corruption, anti-creditor bias, and other factors, all of which have constrained lending and/or added to loan costs. Thus, assessing the degree to which contract enforcement practices enable the market involves numbers of procedures, time required, and costs.

Contract enforcement procedures are most numerous in CEE SOUTHERN TIER countries (40 in 2010; 42 among PFS Beneficiary countries), but not too different in EURASIA (37 in 2010; 36 among PFS EURASIA), and least numerous as a region in CEE NORTHERN TIER (32 in 2010). These figures compare with 35 in Turkey, 32 in the Eurozone, and 38 in Croatia. Thus, there is little difference among the regions. Among PFS Beneficiary countries, EURASIA ranged from a low of 28 in **Belarus** to a high of 49 in **Armenia,** with **Azerbaijan, Georgia, Moldova** and **Ukraine** in between. As for PFS Beneficiary countries in CEE SOUTHERN TIER, **Serbia** (36) had the fewest steps while **Kosovo** had the most (53), with **Albania, Bosnia, Macedonia** and **Montenegro** in between.



Time required to enforce contracts is varied, with CEE NORTHERN and SOUTHERN TIER countries (588 and 513 days, respectively, in 2010), which is high when compared to EURASIA (300 days) but fewer than the Eurozone (608 days in 2010). (Turkey required 420 days and Croatia required 561.) EURASIA showed variation, with **Azerbaijan** (237) and **Belarus** (225) at the low end, **Armenia and Georgia** (285) near the regional average, and **Moldova** (365) and **Ukraine** (345) requiring more time. In the PFS CEE SOUTHERN TIER countries, there was also considerable variation, with **Albania** (390), **Kosovo** (420), **Macedonia** (370) below the regional average, while **Bosnia** (595), **Montenegro** (545) and **Serbia** (635) were above the regional average.



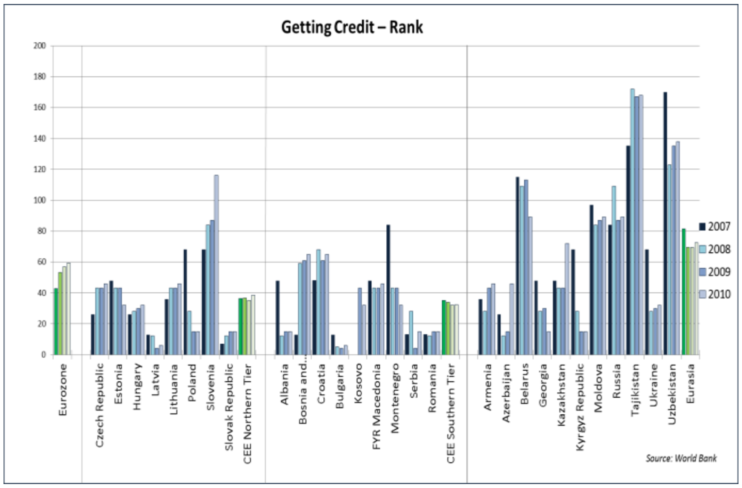
As for contract enforcement costs (as measured by the percent of debt expended in loan/debt recovery efforts), there is regional variation. In 2010, CEE NORTHERN TIER had the lowest average costs, at 22 percent in 2010. EURASIA was also relatively low, with average costs at about 24 percent (25.5 percent for the PFS Beneficiary countries). These costs are higher in CEE SOUTHERN TIER where the average cost was 32.5 percent (37.7 percent in PFS Beneficiary countries) in 2010. All of this compares with 18.3 percent in the Eurozone, 18.8 percent in Turkey, and only 13.8 percent in Croatia.

In general, most countries have kept these costs at or below 30 percent on average from 2007-10. Among the PFS Beneficiary countries in CEE SOUTHERN TIER in 2010, **Albania** (38.7 percent), **Bosnia** (38.4 percent), **Macedonia** (33.1 percent), and **Kosovo** (61.2 percent) were above the 30 percent threshold, whereas and **Montenegro** (25.7 percent) and **Serbia** (28.9 percent) were below. In EURASIA, all PFS Beneficiary countries were at or below the 30 percent threshold except **Ukraine**, which had costs of 41.5 percent in 2010.

8.3. Getting Credit and Credit Information

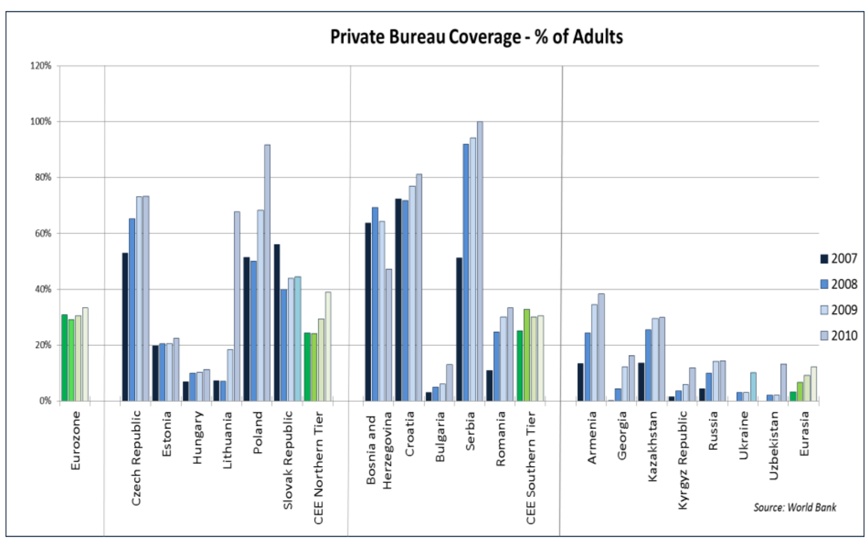
Access to finance is addressed above, yet is also a reflection and function of the business environment. As such, a general evaluation of access, as well as the information made available to enable credit decision-making, is important as part of the overall evaluation of the business environment.

In general, credit in 2010 appeared to be most accessible in CEE SOUTHERN TIER countries, followed by CEE NORTHERN TIER countries and then EURASIA. The average ranking for CEE SOUTHERN TIER was 32 in 2010, little changed over the prior three years, and basically the same for the PFS Beneficiary countries (34) which did show significant improvement from 2007. **Albania** (15), **Kosovo** (32), **Montenegro** (32) and **Serbia** (15) were all at or below the regional average, whereas **Bosnia** (65) and **Macedonia** (46) were above the regional average. CEE NORTHERN TIER countries' average ranking was 38.5 in 2010, representing a slight deterioration from 2007 and very likely reflecting the pull-back in credit following the 2007-08 financial crisis. However, in both cases, the regions continue to have reasonable access to credit. By contrast, EURASIA showed an average ranking of 73 in 2010, reflecting far greater difficulty on average in accessing credit than in the CEE regions. On a more positive note, access has improved from 2007, and the PFS EURASIA Beneficiary countries' ranking was 53 in 2010. Thus, in EURASIA, the main challenges are found in Central Asia (apart from the Kyrgyz Republic), although **Belarus, Moldova** and Russia also faced major challenges in accessing credit in 2010. By contrast, **Armenia and Azerbaijan** (46), **Georgia** (15) and **Ukraine** (32) were below the regional average, with **Georgia and Ukraine** in particular having increased access to credit since 2008. (As noted, **Ukraine** has also faced significant loan quality problems.) All of this compares reasonably favorably with the Eurozone (53), Turkey (70) and Croatia (65).

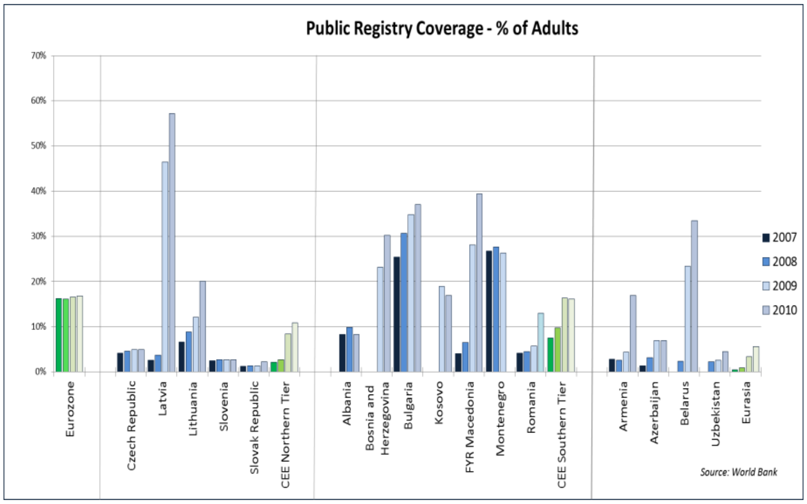


Access to relevant credit information on borrowers by lenders is essential in developing the credit market. Thus, public and private credit information services are needed to accommodate credit information needs. Public registries are generally more limited in terms of information provided, usually consisting of negative information. By contrast, private credit bureaus are often in a position to provide information on positive performance as well.

As for public registries, CEE SOUTHERN TIER countries showed the highest level of coverage (as a percentage of adults) , followed by CEE NORTHERN TIER countries and then EURASIA (the last skewed by several countries with no coverage). The average coverage for CEE SOUTHERN TIER was 16.1 percent in 2010, comparable to the Eurozone (16.8 percent coverage). This represents a sizeable increase in coverage from 7.5 percent in 2007. **Albania** (8.3 percent) is fairly low in its public registry coverage ratio, and **Kosovo** and **Serbia** have no public registry coverage at all. However, **Bosnia**



(30.2 percent) and **Macedonia** (39.4) were well above the regional average. **Montenegro** had no coverage in 2010, but had 27 percent coverage in 2007-09. CEE NORTHERN TIER countries' average coverage was 10.9 percent in 2010, representing a significant increase since 2007 when coverage was only 2.1 percent. By contrast, EURASIA showed average coverage of only 5.6 percent in 2010, although that is also a major increase from 0.5 percent in 2007. PFS EURASIA Beneficiary countries' coverage was nearly 10 percent in 2010, a major increase from less than 1 percent in 2007. Thus, while low, EURASIA is expanding its coverage ratios, as are the CEE regions. **Belarus** (33.5 percent) and **Armenia** (16.9 percent) have high ratios for the region, while **Azerbaijan** is consistent with the PFS EURASIA average (7 percent). **Moldova, Georgia** and **Ukraine** have no coverage, which also brings down the regional average. All of this compares with the coverage ratios of the Eurozone (16.8 percent) and Turkey (18.3 percent). (Croatia has no public registry.)

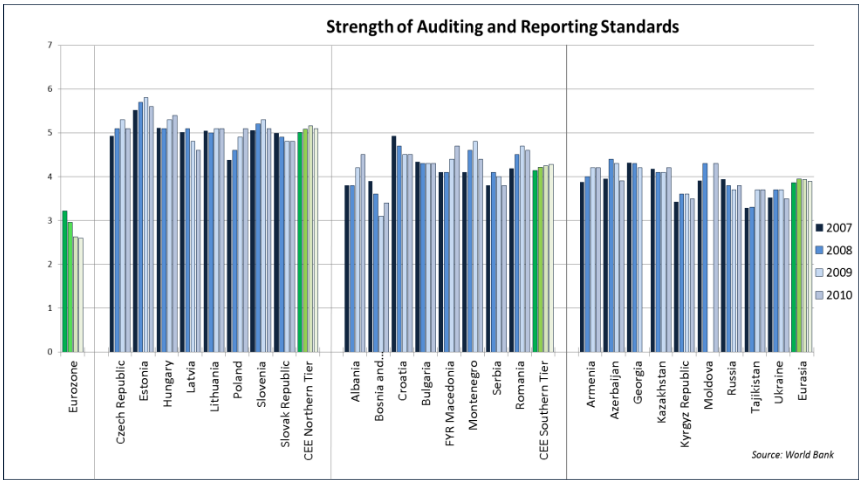


Regarding private bureau coverage, CEE NORTHERN TIER countries showed the highest level of coverage (as a percentage of adults) , followed by CEE SOUTHERN TIER countries and then EURASIA. The average coverage for CEE NORTHERN TIER was 38.9 percent in 2010, above the Eurozone coverage ratio of 33.4 percent. This represents a sizeable increase in regional coverage from 24.3 percent in 2007. CEE SOUTHERN TIER countries' average coverage was 30.5 percent in 2010, representing an increase since 2007 when coverage was 25.2 percent. Among PFS Beneficiary countries, where coverage ratios are slightly lower than the region as a whole, the results are entirely skewed because private bureaus have not established themselves in four of the six countries (**Albania, Kosovo, Macedonia** and **Montenegro**). By contrast, **Serbia** had full (100 percent) coverage of adults, and Bosnia had a high 47 percent ratio in 2010. EURASIA showed average coverage of 12.2 percent in 2010, up from 3.3 percent in 2007. PFS EURASIA Beneficiary countries' coverage was nearly 11 percent in 2010, a major increase from 2.3 percent in 2007. Thus, while low, EURASIA is slowly expanding its coverage ratios. **Armenia** (38.3 percent) and **Georgia** (16.4 percent) have made the most progress since 2007, while **Ukraine** (10.1 percent) has also made headway. However, **Azerbaijan**, **Belarus** and **Moldova** have no private credit bureau coverage at all, which also brings down the regional average. All of this compares with the private credit bureau coverage ratios of the Eurozone (33.4 percent) and Turkey (42.2 percent) and Croatia (81.2 percent).

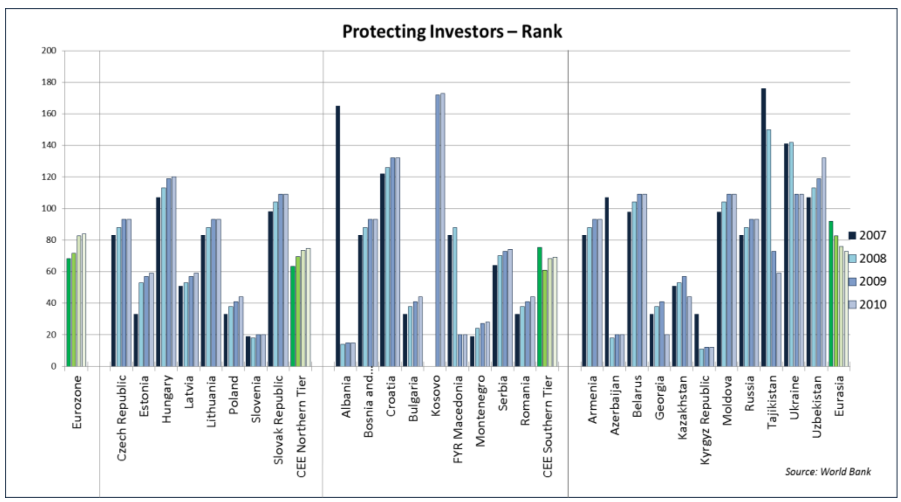
When combining coverage ratios between public registries and private credit bureaus, the 2010 figures show the CEE NORTHERN TIER countries (49.8 percent) are virtually identical to the Eurozone (50.2 percent), with CEE SOUTHERN TIER slightly lower (46.6 percent; PFS at 40.3 percent) and EURASIA the lowest (17.8 percent; PFS at 20.4 percent). Thus, the PFS Beneficiary countries have room to improve their coverage ratios, although they have also shown increases in ratios since 2007. (Turkey had a 60.5 percent ratio in 2010, and Croatia was at 81.2 percent.)

8.4. Investor Protection

Investor protection is essential for the volume as well as the value of investment into businesses. At the firm level, investors will commit less equity where the business environment is unstable or risky. As such, legal and institutional protection that is consistently enforced is needed to offset other market risks that are faced by investors. The weaker the protection, the weaker the likelihood of investment into the country. This includes measures to protect minority shareholder rights against abuses by majority shareholders, including adequate disclosures, protection against insider dealings and transactions, and an effective court system that permits legal challenges when violations have occurred.



Rankings of countries and regions on investor protection indicate that legal protections lag Eurozone standards in all three regions. Based on the rankings, the average 2010 ranking for the Eurozone was 84, followed by CEE NORTHERN TIER countries (75), EURASIA (73, with PFS at 77), and then CEE SOUTHERN TIER countries at 69 (PFS at 67). These rankings may be true in a narrow legal interpretive sense, although the rankings do not seem to account for the performance of the courts or *de facto* effectiveness of disclosures, minority shareholder protection against insider dealings, etc. Thus, it could be that including enforcement mechanisms into the mix would yield greater variance in the rankings. However, based on the 2010 rankings, among PFS Beneficiary countries in CEE SOUTHERN TIER, rankings ranged from a high of 173 in **Kosovo** to a low of 15 in **Albania**. In EURASIA, among PFS Beneficiary countries, the highest ranking was for **Moldova and Ukraine** (109), and the lowest was in **Azerbaijan and Georgia** (20). (Turkey had a ranking of 59, and Croatia had a ranking of 132.)



8.5. Auditing and Reporting Standards

According to the World Economic Forum (WEF), on a scale of "2" (lowest) to "7" (highest), auditing and reporting standards are strongest in CEE NORTHERN TIER (5.10 in 2010), then CEE SOUTHERN TIER (4.28; 4.16 in PFS Beneficiary countries), followed by EURASIA (3.89; 3.98 in PFS Beneficiary countries). At the high end among all countries under review (above "5" in 2010) are Estonia (5.6), Hungary (5.4), Slovenia (5.1), Czech Republic (5.1) and Lithuania (5.1). At the low end (below "4" in 2010) are **Azerbaijan** (3.9), **Serbia**, Mongolia and Russia (3.8), Tajikistan (3.7), Kyrgyz Republic (3.5), **Ukraine** (3.5) and **Bosnia** (3.4). The other countries, including the other

PFS Beneficiary countries for which data are available[33], were in the "4"-"5" range. (It is uncertain how accurate these measures are, as the scores are based on survey perceptions. For instance, it is unclear if **Bosnia's** score should be the lowest in 2010 among all countries reviewed.)

By comparison, Turkey scored "4.4" in 2010, and Croatia was "4.65", both below the CEE NORTHERN TIER average but higher than CEE SOUTHERN TIER. (Among advanced economies, Eurozone countries have emerged from these rankings at a low "2.59", which does not seem plausible.)

[33] There were no data for Belarus or Kosovo.

9. Methodological Notes

Regional Groupings

Regional groupings are as follows. PFS Beneficiary countries are in bold.

- CEE NORTHERN TIER: Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, Slovenia.
- CEE SOUTHERN TIER: **Albania, Bosnia**, Bulgaria, Croatia, **FYR Macedonia, Kosovo, Montenegro**, Romania, **Serbia**.
- EURASIA[34]: **Armenia, Azerbaijan, Belarus, Georgia**, Kazakhstan, Kyrgyz Republic, **Moldova**, Russia, Tajikistan, Turkmenistan, **Ukraine**, Uzbekistan.

Advanced economies are generally presumed to be Eurozone. Any Central European countries that are members of the OECD and/or Eurozone have been netted out of the data when possible, such as in the Global Financial Stability Report data for advanced economies that include non-Eurozone countries. In this case, data on advanced economies used in the report exclude data for the Czech Republic, Slovakia and Slovenia as these are included in the Central Europe/Baltic group. Thus, advanced economies (from Global Financial Stability Report) include Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Hong Kong, Iceland, Ireland, Israel, Italy, Japan, Korea, Luxembourg, Malta, Netherlands, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, United Kingdom, United States. However, where data are grouped (e.g., Euro Area), data may or may not be netted. For instance, Euro Area data include data from the Czech Republic, Slovakia and Slovenia.

Benchmark Countries

In addition to the above, performance measures of the subject regional groups were often compared to Turkey, Croatia and Korea. Turkey has been selected because it is included in the EBRD data, and has a chance of joining the European Union in the future. Croatia was selected because it is currently negotiating membership with the European Union while also being a part of the CEE SOUTHERN TIER. Korea was selected because of its advanced economic status, without having figures that are aberrational or out of reach in the coming decades for some of the subject countries. Moreover, Korea has developed its economy over the last several decades and weathered the East Asian financial crisis in 1998. Therefore, Korea is relevant in many ways for PFS Beneficiary countries as a successful example from which to learn.

Regional Averages

Regional averages are simple averages by country, and not weighted by measures such as GDP.

Outliers have been excluded from regional averages. However, in some cases, the data are skewed and unrepresentative due to the limited data reported for the region. As such, a single country data set can be relevant while also serving as a bit of an outlier due to the small sample set. Under such conditions, the data were included for comparison with other regions, and the potential distortion resulting from the small sample set is noted in the report.

[34] Mongolia is not a part of USAID's EURASIA group, and its figures have not been included in regional averages. However, it has been included in the statistics as part of the EBRD 29, and references to its performance are made in the report .

Measures

Most measures are percentages. In some cases, these are averages for 2007-2009 or 2007-2010. In other cases, the most recent measure is used. The regional averages are calculated to be accurate in terms of the number of countries (as data are not always available for all countries) and the specific numbers of years for which data are available (as data are not always available every year).

Ex: Data for a country from 2007-08 that is averaged would have a denominator of "2", whereas data averaged for 2007-09 would have a denominator of "3".

Relevant Range

The relevant range is set based on low-to-high parameters of the data set that serve as the base for establishing the distribution that provides the parameters for establishing scores based on a segmented distribution (e.g., based on quintiles).

Ex: (1) Lowest Return on Assets = -2.0 percent; (2) Highest Return on Assets = 6.0 percent; therefore, (3) Relevant Range = 8.0 percent.

In this case, a high score is positively correlated with a high return rate. So 6.0 percent would receive a score of "5", and negative 2 percent would receive a score of zero percent.

Not all patterns are linear. In some cases, bell curves or other distributions are utilized to arrive at an accurate score.

Country Ranking

The country ranking is the score for the country by category that correlates with its position in the scale. Scores in between the highest ("5") and lowest ("0") are based on a sliding scale. Thus, it is entirely possible to have a disproportionate number of countries in a narrow (e.g., "0-1", "1-2") range.

Ex: If 23 of 27 countries have Return on Assets of negative 1.9 percent, almost all countries would be close to "0" on the scale, even if one country with a 6 percent RoA ratio is a "5".

Quintile Scale

The scores are based on a simple division of the relevant range into five separate categories to allow for a simple scoring of country performance against the performance of others. As the scale is based on quintiles, the scoring is a "0-5" system.

Ex: Based on the Relevant Range example above for Return on Assets (RoA), each quintile would cover 1.6 percent in value. Thus, "0" would be those with RoA from -2.0 percent to -0.4 percent; "2" would be those with RoA from -0.4 percent to 1.2 percent; "3" would be those with RoA from 1.2 percent to 2.8 percent; "4" would be those with RoA from 2.8 percent to 4.4 percent; "5" would be those with RoA from 4.4 percent to 6.0 percent.

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